Spring 5-12-2020

A Compilation of Accounting Case Studies

Richard Brohaugh

A COMPILATION OF ACCOUNTING CASE STUDIES

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

Oxford May 2020

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ABSTRACT

RIDGE BROHAUGH: A COMPILATION OF ACCOUNTING CASE STUDIES

(Under the direction of Dr. Victoria Dickinson)

This thesis compiles twelve case studies provided by Dr. Victoria Dickinson. Each of these cases, which were performed over the course of the 2018-2019 academic year, presented accounting problems that used both fictional and real-world situations to provide an experiential approach to learning. These cases presented numerous types of business problems and challenged me to better understand the various dimensions of accountancy, ranging from data analytics to banking and finance. The procedures used to gather solutions and data for each of the cases were unique, but for each case, I was able to learn how to research potential issues and present solutions in a concise manner.

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Data Analytics Case #1: Alteryx

Ridge Brohaugh

Dr. Dickinson

5 September 2018

On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this assignment. *Ridge Brohaugh*

Executive Summary:

For this case study, I researched Alteryx, a data analytics platform that facilitates the management of data for companies and organizations. Through its four flagship products (Designer, Server, Connect, and Promote), this software program offers a wide variety of tools that gather, filter, and arrange data into information that businesses can use to develop strategic plans. Alteryx sets itself apart from other data analytics programs through its end-to-end structure that offers various functions in one place, so businesses don't have to use tools from different programs and transfer them from platform to platform. Its main purpose is to blend data from many sources, allowing users to track trends, discover discrepancies, and manage controls.

As an accounting firm managing tax and audit services, software that provides data analytic functions is paramount to an efficient, competitive firm within the industry. As data becomes more recognized as an asset, being able to contain and extract valuable data bring value to both my firm and my client. Alteryx would allow my employees to be more productive with their time and either take on more clients or provide higher quality feedback to existing customers.

1. **Identify the history and purpose of this tool and describe, in general, how it is used to make business decisions. Be specific about what kind of technology it uses, etc. and other resources that need to be in place to fully utilize the functionality of the tool.**

Alteryx serves as a software based platform designed to perform advanced analytics, breaking down nearly immeasurable quantities of data from various sources into more manageable sets of information. As economies become increasingly data driven, the need for companies and organizations to analyze the overwhelming amount of data available to them is crucial to high performance and successful internal management. Alteryx empowers its users to overcome the complicated nature of data analytics by simplifying the process of gathering and managing data into four separate products: Designer, Server, Connect, and Promote. Each of these products provide users with distinct functions that collaborate data throughout the users' organization, creating an environment where data can be communicated clearly across all divisions.

Designer, Alteryx's first product, combines various data processing tools that allows its users to gather and filter data in one place, instead of having to shift between multiple platforms and individuals. This multifunctional tool facilitates the arduous process of blending data from numerous types of sources, thus giving businesses more time to develop insights from their data. Another product in Alteryx's platform is Server, which scales and automates its centralized server based on the company's needs and delivers simultaneous access to authorized users. With this data, Alteryx offers a unique form of cataloguing through its Connect function. Connect organizes data based on human insight and provides advanced searching capabilities, minimizing the time spent seeking relevant data. The last product in Alteryx's platform is Promote, which provides an end-to-end system that implements predictive models for faster production without the need for code.

As an overall platform, Alteryx is designed to manage the multitude of internal and external data available to companies and organizations. Through its platform, data can be translated into valuable information that businesses can use to analyze their business processes and market environments. Using this analysis, businesses can then determine the most effective strategies to implement for long-term success.

2. **How, specifically, would you use the tool in the following business settings? Create at least three specific scenarios for each category in which the tool would lead to more efficiency an/or better effectiveness. Be sure to describe what kinds of data your tool would use for each scenario.**

a. **Auditing**

For a firm looking to perform audits, Alteryx provides comprehensive tools that can assist in multiple aspects of auditing. Internal controls, for instance, are vital to the legitimacy of any company, so an increase in protection over these controls provides value to both the company and the auditing firm. One method to secure internal controls is to develop simple, comprehensive business models that provide a blueprint for each step of a company's business process. Alteryx makes this process simple through its predictive modeling tool found in Alteryx Promote. By developing simple models, auditors (both internal and external) can quickly grasp more complex business processes, which frees the auditor to spend more time considering recommendations for companies' current operations.

Maintaining faithful representation is another important aspect of the audit that Alteryx can assist in. Through its Big Data manager, Alteryx Designer, audit firms can gather all the data that a company generates and analyze it to check for inconsistencies. By filtering financial information such as those found on a company's balance sheets or income statements, Alteryx could identify balances that do not match or locate outliers within the data that need further investigation. For example, in the case of asset misappropriation, data can be traced through a company's assets and matched to their bank statements to check that the flow of money is appropriated correctly.

Another way Alteryx can help with auditing is through its capacity to quickly load and manipulate data from many sources. In Alteryx Designer, an auditing firm could quickly run the data from the company its auditing and compare that data to those of competitors within its market. By evaluating how it handles its financial information, an auditor could locate patterns between the various competitors and quickly detect variations from that pattern.

b. Tax Planning

Not only can Alteryx play a huge function in the role of auditing, but it can also provide assistance when managing company taxes. If, for instance, the government decided to change the laws regarded the taxations of certain revenues, Alteryx Designer could use its predictive analytics to set up repeatable workflows, factoring in these regulation changes. By inputting these changes into a predictive analytical software, the data could be manipulated both from the past and into the future. So, to see how the tax law changes would directly affect the financial statements, one would simply have to input the new rule, no coding necessary.

This same predictive analysis software found in Alteryx Designer could also be used to predict changes in profitability based on various taxation methods. As a firm providing tax accounting solutions, showing clients exactly how much money they could receive in tax returns is incredibly valuable on both ends of the deal. Predicting returns can validate financial compensation for the tax firm, especially if those numbers are confirmed once the returns are made. Computing these figures and comparing them over the short and long term gives employees discernment for future decisions and provides immediate information for decision making.

Alteryx Designer is created to manage innumerable quantities of data and then use that data to discover valuable information. In respect to tax, Designer can be utilized as a tool for discovering trends in the tax environment. By understanding how others in the market are responding to tax changes, firms can better determine which counter methods are effective and which aren't. By using other companies' trials and errors, one can minimize preventative financial mistakes and thus be more profitable moving forward.

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

As a firm looking to provide reputable audit and tax services, our team should certainly invest in the acquisition of and training in Alteryx. We practice in a quickly developing society, and our firm strives to remain technologically relevant. If the profits exceed the costs and the software's adoption makes it easier not harder for our employees, then there is no reason not to incorporate Alteryx into our company. Alteryx facilitates the arduous task of culminating data and arranging it into valuable information, which saves our employees time and energy. This time and energy can then be focused on analyzing the data, not forming and manipulating it.

In business, firms that refuse to keep up inevitably end up falling behind. We won't be such a company because Alteryx is a strong future investment that will provide significant returns and reduce unnecessary "busy work." It will allow our firm to manage more clients at one time, which could also bring in enough revenue to hire more employees. Big data is ingrained in the industry of modern business, so to compete with other accounting firms, we need software that will allow us to handle the massive quantities of data that businesses are attempting to tap in to.

Alteryx is an end-to-end platform that offers various tools our firm can use to perform various audit and tax services. This prevents us from having to transfer data from one tool to the other and keeps all our data (and our client's data) secure in one place. Our companies require strict adherence to the safekeeping of another company's information, so keeping this information secure is a necessity. With all these factors, adopting Alteryx into our business platform is a safe investment with comfortable returns in the future.

Works Cited

"Leader In Data Science + Analytics | Alteryx". *Alteryx.Com*, 2018, https://www.alteryx.com/. Accessed 5 Sept 201

Case 2: Rocky Mountain Chocolate Factory

Ridge Brohaugh

Dr. Dickinson

5 September 2019

On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this assignment. *Ridge Brohaugh*

Executive Summary

Throughout this study, I learned to familiarize myself with Excel. After this case, I've found Excel to be less intimidating and full of helpful tools/functions that promote easy calculations. For example, Excel offers options to copy and paste entries (keeps term consistency) and allows for adaptive functions (that help copy and past adaptive functions). Also, I've learned to visualize exactly how adjusting entries and closing entries look from a broader perspective throughout the period. Not only does this help me understand the accounting cycle as a whole, but it also reinforces specific concepts that I already knew.

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

I expect to see accounts established Accounts Receivables, Cash, Accounts Payable, Inventory, PPE, Common Stock, Notes Payable, Retained Earnings, and other major accounts that are used on most balance sheets. The major assets will probably be cash, accounts receivables, inventory, equipment, plants, and property. Major liabilities consist of accounts payables, unerned revenues, and notes payables.

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

Depreciation, Wages, and Inventories all need to be adjusted.

		Beginning Balance (Febraury 28, 2009)	1. Purchase Inventory	2. Incur Factory Wages	3. Sell Inventory for Cash and on Account	4. Pay for Inventory	5. Collect Receivables	6. Incur SG&A (Cash and Payable)	7. Pay Wages	8. Receive Franchise Fee	9. Purchase PPE	10. Dividends Declared and Paid	11. All Other Transactions	Unadjusted Trial Balance	12. Adjust for Inventory Count	13. Record Depreciation	14. Wage Accrual	15. Consultant's Report	Pre-closing Trial Balance	16. Closing Entry	Post-Closing (Ending) Balance	Actual February 28, 2010 F/S Figures
	Cash and Cash Equivalents	1,253,947			17,000,000	-8,200,000	4,100,000	-2,000,000	-6,423,789	125,000	-498,832	-2,403,458	790,224	3,743,092					3,743,092		3,743,092	3,743,092
	Accounts Receivable	4,229,733			5,000,000		-4,100,000						-702,207	4,427,526					4,427,526		4,427,526	4,427,526
	Notes Receivables, Current	0											91,059	91,059					91,059		91,059	91,059
	Inventories	4,064,611	7,500,000	6,000,000	-14,000,000								-66,328	3,498,283	-216,836				3,281,447		3,281,447	3,281,447
	Deferred Income Taxes	369,197											92,052	461,249					461,249		461,249	461,249
Dr.	Other	224,378											-4,215	220,163					220,163		220,163	220,163
	Property and Equipment, Net	5,253,598									498,832		132,859	5,885,289		-698,580			5,186,709		5,186,709	5,186,709
	Notes Receivable, Less Current Portion	124,452											139,198	263,650					263,650		263,650	263,650
	Goodwill, Net	1,046,944												1,046,944					1,046,944		1,046,944	1,046,944
	Intangible Assets, Net	183,135											-73,110	110,025					110,025		110,025	110,025
	Other	91,057											-3,007	88,050					88,050		88,050	88,050
	Accounts Payable	1,074,643	7,500,000			-8,200,000							503,189	877,832					877,832		877,832	877,832
	Accrued Salaries and Wages	423,789		6,000,000					-6,423,789					0			646,156		646,156		646,156	646,156
	Other Accrued Expenses	531,941						3,300,000					-2,885,413	946,528					946,528		946,528	946,528
	Dividend Payable	598,986										3,709	-1	602,694					602,694		602,694	602,694
	Deferred Income	142,000								125,000			-46,062	220,938					220,938		220,938	220,938
Cr.	Deferred Income Taxes	827,700											66,729	894,429					894,429		894,429	894,429
	Common Stock	179,696											1,112	180,808					180,808		180,808	180,808
	Additional Paid-In Capital	7,311,280											315,322	7,626,602					7,626,602		7,626,602	7,626,602
	Retained Earnings	5,751,017										-2,407,167		3,343,850					3,343,850	3,580,077	6,923,927	6,923,927
	Sales	0			22,000,000								944,017	22,944,017					22,944,017	(22,944,017)	0	22,944,017
	Franchise and Royalty Fees	0											5,492,531	5,492,531					5,492,531	(5,492,531)	0	5,492,531
	Cost of Sales	0			14,000,000								693,786	14,693,786	216,836				14,910,622	(14,910,622)	0	14,910,622
	Franchise Costs	0											1,499,477	1,499,477					1,499,477	(1,499,477)	0	1,499,477
	Sales and Marketing	0						1,505,431						1,505,431					1,505,431	(1,505,431)	0	1,505,431
	General and Administrative	0						2,044,569					-261,622	1,782,947			639,200		2,422,147	(2,422,147)	0	2,422,147
Dr.	Retail Operating	0						1,750,000						1,750,000			6,956		1,756,956	(1,756,956)	0	1,756,956
	Depreciation and Amortization	0												0		698,580			698,580	(698,580)	0	698,580
	Interest Income	0											-27,210	-27,210					-27,210	27,210	0	-27,210
	Income Tax Expense	0											2,090,468	2,090,468					2,090,468	(2,090,468)	0	2,090,468
	A = L + OE + R - E	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	-3,580,077

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

Revenues		
Sales	$ 22,944,017	
Franchise and Royalty Fees	5,492,531	
Total Revenues		$ 28,436,548
Costs and Expenses		
Cost of Sales	14,910,622	
Franchise Costs	1,499,477	
Sales and Marketing	1,505,431	
General and Administrative	2,422,147	
Retail Operating	1,756,956	
Depreciation and Amortization	698,580	
Total Costs and Expenses		22,793,213
Operating Income		5,643,335
Other Income (Expense)		
Interest Expense	0	
Interest Income	27,210	
Other, net		27210
Income Before Tax Expense		5,670,545
Income Tax Expense		2,090,468
Net Income		$ 3,580,077
Shares Outstanding	6,012,717	
Earnings Per Common Share	$ 0.60	

Rocky Mountain Chocolate Factory, Inc
Balance Sheet
For the Year Ended February 28, 2010

ASSETS		
Current Assets		
Cash and Cash Equivalents	$ 3,743,092	
Accounts Receivable	4,427,526	
Notes Receivables, Current	91,059	
Inventories	3,281,447	
Deferred Income Taxes	461,249	
Other	220,163	
Total Current Assets		$ 12,224,536
Property and Equipment, Net		5,186,709
Other Assets		
Notes Receivable, Less Current Portion	263,650	
Goodwill, Net	1,046,944	
Intangible Assets, Net	110,025	
Other	88,050	
Total Other Assets		1,508,669
TOTAL ASSETS		**$ 18,919,914**
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Accounts Payable	877,832	
Accrued Salaries and Wages	646,156	
Other Accrued Expenses	946,528	
Dividend Payable	602,694	
Deferred Income	220,938	
Total Current Liabilities		3,294,148
Deferred Income Taxes		894,429
Stockholders' Equity		
Common Stock	180,808	
Additional Paid-In Capital	7,626,602	
Retained Earnings	6,923,927	
Total Stockholders' Equity		14,731,337
TOTAL LIABILITIES AND SEQ		**$ 18,919,914**

Transaction	Cash Flow Section
1	Operating
2	Operating
3	Operating
4	Operating
5	Operating
6	Operating
7	Operating
8	Operating
9	Investing
10	Financing
11	NA
12	Operating
13	Operating
14	Operating
15	NA

Case 3

Ridge Brohaugh

Dr. Dickinson

19 September 2018

On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this assignment. *Ridge Brohaugh*

Executive Summary:

In this case, we debated different scenarios that we may encounter as students pursuing a degree in accountancy. While these may seem like very specific questions to very specific situations, I now understand that they force you to consider an accounting career from a much broader perspective. As students at this school (Ole Miss), we are privileged to have the opportunities that we have, so it is our responsibility to handle these opportunities maturely by taking ownership and understanding what the firms want from us. The corporate world is not just "some game that we have to play;" it is made up of people, like you and me. The lesson I learned throughout this case is that transparency, above all else, is what each party deserves. By being transparent, we communicate our intentions and allow every step to be clear to those around us.

While this may be a challenge at times, seeing the world as something to give to instead of take from, allows us to carry ourselves with more dignity and maturity. We are reaching an age where we must learn to hold our opinions but also respect others'. Whether its through our decision to enroll in law school, work in investment banking, or transfer to a different location, being transparent will ultimately guide us there.

1. **Instead of following through with the masters of accountancy, a student is considering going through a law school program after graduating from undergraduate school. Do you agree with this decision?**

When comparing the decision between law school and a masters of accountancy program, I believe the masters of accountancy provides its graduates with more opportunities at lower costs. To start, receiving a masters of accountancy degree (at least at Ole Miss) takes students only one year, which is two years less than that of law school. As a future employee, I recognize the value of experience in a field of work, so being employed by a company after only one year of graduating from an undergraduate degree provides two full years of experience that I wouldn't have if I had stayed in law school. Those two years would provide me with a considerable head start that I can leverage to advance my career.

Even if I didn't want to work in public accounting my entire career, the experience and knowledge that I'll gain from working in the field of accounting will give me greater flexibility long-term. Accounting, as a field of knowledge, contains a deep foundation for the language and organization of business, which can provide a unique, yet practical, perspective to any economic entity. For example, if I decided to own my own business after working in accounting for ten years, my idea(s) would launch the start-up's beginning; however, the fundamentals I learned through my accounting background would help maintain my business's finances. For businesses to thrive, they must have their finances covered, regardless of how great of an idea that business is.

Not only does the masters in accountancy provide career flexibility, but it also provides lower costs and similar returns. Even if year to year costs were the same between law schools and masters of accountancy programs (law school is generally more expensive), law school requires two additional years of significant costs. Most students in law school have not had salaried jobs yet, so making these payments often require student loans. These loans increase the price even more, and make it more difficult for people to pay their debts off quickly when they do find jobs. Meanwhile, accounting graduates have already worked two years to pay off their one year of additional school. While the student in law school is spending money to finish their education, the graduate in accountancy is working for an employer and beginning his or her career.

The counter argument to this is that graduating in law school provides higher returns. While I may agree that graduates from a law school could receive higher incomes at first, I don't believe that that is the case throughout one's career. I believe that both careers level out after a certain amount of time. So, in comparison, as a young employee, I wouldn't want to spend the first ten years of work paying off my student loans. This will give me much more financial freedom and confidence to do the things in life that I want to do, outside of work and school

2. **A student believes that graduating with an accounting degree from Ole Miss is better, even if he or she wants to work in investment banking. Is this a reasonable decision?**

Ole Miss's accountancy school is currently ranked 7th in the nation, so it is reasonable to assume that graduating with this major can be a potential doorway in to the field of investment banking; however, I don't believe this is the decision a student should make. Instead, I believe that a student should study investment banking through whatever degree is closest to that field, such as banking and finance.

From my perspective, accounting and investment banking are both very technical fields of business. What I mean by this is that, besides the general concepts of each, the intricate nuances between the two don't give advantages to the other once switched. So, if I wanted to do investment banking throughout my career (and was resolute on that idea), then the idea of spending four years of college studying accounting seems unreasonable. Why would I not want to spend college studying the field of work that I want to do, developing my human capital on the subject to set myself apart.

This student is basically suggesting that he or she wants to major in accounting, obtain a master's degree in accounting, work two to three years in an accounting firm, and then shift careers to investment banking. At this point, that student is five to six behind another student, who has studied investment banking in college for four years, received a master's degree in business administration, and worked with an investing firm for a year or two. To be a high performer in today's fast paced world, one has to hone in on its field to develop insights that others don't have. If this student studies and learns about the technicalities of accounting, he or she is missing the opportunities to grow their knowledge of investment banking.

3. **A student is looking to switch locations with a firm, right before he or she leaves to go work for them in a particular city. Is it reasonable to ask for a transfer request, or should the student follow through with its commitment to that city?**

While I believe it is reasonable to ask for a transfer request in the case of emergencies, I do not believe that it is professional or respectful to ask for a transfer request in the event of altered location preferences. Companies devote significant time and money to establish potential recruits in limited job slots, so when an employee asks for a transfer request before he or she has even worked there, it puts a considerable amount of risk on the company. Not only does the company now have to take the time to manage the request, but it also has to pay to recruit another potential employee for that previously-trained job opening.

In the event that an employee does desire a change of location, he or she should contact their employer about the issue immediately. It's assumed that the student in this scenario has already done their internship in this city, so if their preference on the location changed, they should have informed their employer immediately. Waiting until a few months before working in that location is irresponsible as a potential employee, and it highlights the potential risk that is involved with that person. As with anything in life, transparency on any situation will generally create the most trust and the best communication between parties.

Case 4: Generic Bank

Ridge Brohaugh
Dr. Dickinson
October 3 2018

On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this assignment. *Ridge Brohaugh*

Executive Summary:

In this case, we were presented with the opportunity to perform a hypothetical audit evaluation for debt security impairment in the event of security sales. Using "Generic Bank's" background information, balance sheet, income statement, and specific ASC statements, we could determine whether a debt security should be reported as an impairment loss or kept in the comprehensive income section of the balance sheet.

Because impairments rely on judgement from the entity, questions arise as to whether losses should be reported within a period. However, by using the Accounting Standards Codification to guide me in my decision making process, I was able to determine the correct procedures by evaluating the nature of the debt security, the reason for its gain/loss, and most importantly, the intention to sell or keep the investment.

This case taught me how to gather the necessary procedures from the Accounting Standards Codification and apply that information to a reality-based situation. It also showed me how important it is to be clear and comprehensive when establishing standards. The foundation of accounting is the standards and procedures that it rests on, so if they aren't clear for every situation, businesses can find loopholes that harm the consumer.

1. **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 seven securities designated above in 20x2?**

Assuming Generic Bank did sell the securities shortly after year end 20x2, they should record the transaction as an impairment in 20x2. To arrive at this conclusion, the bank must first evaluate whether these investments are traded, held-to-maturity, or available for sale. As mentioned in the case, all Generic Bank's debt securities are available for sale (AFS for short). Because they label them as AFS's, changes in their value do not immediately affect earnings for that period. This means that if there were changes (increases or decreases) in the value of these investments, Generic Bank would not have to report those changes to net income. Instead, the bank could keep these changes classified within comprehensive income.

Next, Generic Bank should determine the causation for the securities' fluctuating values. Often, the value of these debt securities decrease because their bond issuers lose their capacity to make future payments. In this case, however, Generic Bank determines that the changes in the value of these securities are not the effects of credit losses but are due to fluctuations in interest rate. Because the bank's decline in fair value is related to changes in interest rate, the bank must define one more determination.

Generic Bank's AFS debt securities are directly affected by changing interest rates, so it must now determine whether there was an intent to sell during the period. In the case that the bank intended to hold the security to maturity, those debt securities would not be impaired. However, if the bank did in fact have the intent to sell those securities before the maturity date, then those securities would need to be deemed impaired that year.

From the information presented in the case, I believe that Generic Bank had no intention of holding their AFS debt securities to maturity. In section 3 labeled "**Requirements**," it states that Joshua Winters, the bank's CFO, was considering the sale of securities near the end of the period (20x2). From his perspective, he needed to free up liquidity to pay for his employee's year-end bonuses and for potential acquisitions the following year. So, the intent behind these securities requires the bank to impair them. According to Section 326-30-35-10 of the Accounting Standards Codification, "If an entity intends to sell the security… the other-than-temporary impairment shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date."

In conclusion, Generic Bank holds securities that are available for sale, and these securities have fluctuating values caused by changing interest rates. Because the bank intends to sell these securities before their maturity dates, it should report their impairment losses or gains in that year. In this case, Generic Bank should report their impairment losses in 20x2, the year that their intent to sell was recognized.

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

Because Generic Bank has no consistent intention of selling other securities that are significant to their overall portfolio, I do not believe that the bank has an impairment loss on securities other than the seven securities sold. As stated in the case, all Generic Bank's investments in debt securities are available for sale. Unlike traded investments, available for sale investments can be classified as current or noncurrent, and with that in mind, changes in their values do not always have to be recorded to net income. Instead, the recording of impairments is dependent on the terms of credit and the intention of their use.

If the bank can provide reasonable evidence that they have the intent and ability to hold their losses until they're recovered, the bank does not have to impair them. When looking at the case, I can determine that the bank has previously reported AFS securities in the section of the balance sheet titled "Accumulated other comprehensive income." From this, I can assume that Generic Bank, which has been in operations since 1983, has had no intentions of selling these AFS investments in the past. The concern of impairment, however, was brought forth when Joshua Winters established his intent to sell the seven securities. He was worried that selling these securities would alter the perception of their investments.

The bank is in a position where their finances are healthy, and they have accumulated sizeable financial slack in the event of a downturn in business. Their need to establish intention to sell on their securities (their second largest asset class) is nonexistent because they have no reason to accumulate liquidity consistently. The liquidity request brought forth in 20x2 was a "voluntary strategic choice" according to the case study, so the bank can fully recognize this occurrence as an isolate case, with no impact on customary operations in the future. Winters' decision on these seven securities does not reflect the bank's intentions for all their securities, and therefore, should not be impaired for intention to sell, as required by Section 326-30-35-10 of the Accounting Standards Codification.

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?**

Heather Herring works as the manager of the external auditor team for Generic Bank. Her sole role with Generic Bank is to audit the reporting of their financial information, and she bases the validity of their statements on her knowledge and research of accounting principles and guidelines. My answer for the firm's use of impairment losses would remain the same if I were to assume the role of Heather Herring.

The reason for this is simple: she must follow the same concepts and regulations that the bank does. Although she may have more experience (it says that she has no previous experience on this issue) and knowledge of the various accounting procedures, she would ultimately follow the same research that I did to attain my decision on the impairment. Similar to how I gathered my decision, Heather would first determine the nature of the debt securities. Once she's gathered reasonable information on the value and intention of the AFS investments, she would then refer that knowledge to the decision-making guidelines set forth in the Accounting Standards Codification.

However, Heather could suggest recalculating the loans' future effective interest rate because the variations are caused by changing interest rates; however, that choice is ultimately up to the entity (the bank). Section 326-30-35-11 states that, "If the loan's security's contractual interest rate varies based on subsequent changes in an independent factor such as an index or rate…. That security's effective interest rate may be fixed at the rate in effect at the time."

As a bank regulator, however, my goal would be to provide the people (or banks' customers) with clear, comprehensive information. For banks and other financial institutions to remain reliable and in good standing with the public, they must consistently prove dependable. Customers want to know where their money is going, and they deserve to know if or when they can make significant loans or withdrawals. Generic Bank, as a publicly traded company, provides clear financial information; however, it would be even more beneficial for them to provide clear intentions for the use of their debt securities in the notes of their financial statements. As a bank regulator, I would ask that they provide these statements; however, apart from that difference, my answers regarding impairment would not change.

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

If the securities in requirement 1 and 2 accumulate into a net gain, my evaluations of impairment would be determined on an individual level. For the securities that have losses on them, they should be reported as impairment losses and taken out of comprehensive income. However, the securities with individual gains would no longer hold impairment losses, so they should not be reported as such. They would, however, need to be moved from comprehensive income into net income because the intentions to sell them was established in 20x2. As I've stated, if the intention to sell is established, then those assets can no longer be reported in comprehensive income.

Like my assumptions stated prior, my assessment on the securities sold would slightly change if there were individual gains within the securities sold because gains on securities infer that their anticipated future cash flows are recoverable. Impairments “should only be recorded if the anticipated future cash flows are unrecoverable,” so in the event of a gain on securities, the bank should not impair them. However, if there are still some losses on these securities, those securities need to be reported as impairment losses on the balance sheet.

In general, each asset’s sale must be analyzed on an individual basis. If gains were to occur on the sale, then they would need to report those differently than they would on the loss of value on the bank’s securities.

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?**

At this point, if the bank were to sell their AFS securities with gains, it would further establish the bank’s intentions to hold the debt securities until they’ve recovered their amortized costs. For the bank to sell securities with gains on them, the assumption would be that these securities have recovered from their amortized costs. Because they are labeled as available for sale and not hold-to-maturity, the bank has the right to sell these debt securities if the opportunity is presented.

Labeling debt securities as available for sale acknowledges the fact that the bank could sell them if the opportunity and the benefits of sale arose. This does not mean that they were bought with the intention to sell, just that they would sell if the favorable opportunity arose. So, the securities not sold would not be impaired because the direct intention to sell is still not established.

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City Case

Ridge Brohaugh

Dr. Dickinson

7 November 2018

On my honor I pledge that I have neither given, received, nor witnessed any unauthorized help on this assignment. *Ridge Brohaugh*

Executive Summary:

In this case, I conducted research on two cities, Nashville and New York. This investigation provided valuable information for me because I'm quickly approaching the decision to determine where I'll live after college. Having a solidified analysis of various cities gives me a more tangible (and less emotional) understanding of the different possibilities that each city offers. Even though this case limited me to two cities, I can continue the thinking process behind each question and use that to provide a better awareness of the components of each city. Obviously, I have to keep in mind that one of the most important aspects of each location is the office culture at each company, and I won't be able to discern that until I visit them. However, having a grasp on which cities would best suit me will give me a more focused look into where I want to go.

The first city I chose to analyze was Nashville. Even though it's not as populated as that of New York City, it still offered a downtown feel that I could experience. As someone from Mississippi, I've never lived in a large city, so the fact that Nashville has significantly less people is actually an advantage. On top of that, Nashville offers a similar climate and more access to nature, which is important to me. Whether its hiking, kayaking, or running, Nashville provides numerous outlets to enjoy. Nashville is also the heart of the health care industry, which would make my work feel even more meaningful, and it offers many other places to serve such as local churches and charitable organizations.

On the other hand, New York City takes the urban lifestyle to an entirely new level, with a population for the metropolitan area exceeding twenty million people. With such a high population count comes a myriad of opportunities as far as career and life goes. Because NYC is at the center of American business, it offers the ability to work in almost any industry; however, its foremost industry is that of financial services. The myriad of options would be a unique opportunity in New York City because it would offer me the ability to explore various industries and make a better decision on which one would be best for me.

As with most cities in the United States, Nashville and New York each provide their own benefits; however, through my research into each, I determined that Nashville was my primary choice. With an established place in healthcare, I could have my own sizable piece of the market share, and I could specialize heavily into that industry. In addition, Nashville provided the charm of a southern city, while maintaining its urban, downtown lifestyle. Although New York City is still a great possibility, it didn’t match the excitement I found while researching Nashville.

Nashville, Tennessee

Of the many cities to work in throughout the United States, I've chosen Nashville as my top preference. Located halfway between the Gulf of Mexico and Lake Michigan, Nashville is one of Tennessee's largest cities, and its population continues to escalate. Currently, Nashville has a population of nearly 680,000, an 11.8% growth since its population of approximately 600,000 in the 2010 census. Its metropolitan area, also known as "Mid-State," has a much larger population of nearly 2 million, which is nearly equivalent to that of the entire state of Mississippi (my home state).

Geographically, Nashville is located just north of central Tennessee on the Cumberland River in the Central Basin of Middle Tennessee. This river nurtured rich farmland and easy transportation of crops, bringing in money to the development of its city. Although Nashville is in the northern region of Tennessee, it's still located in the humid subtropical climate – much like that of Oxford, Mississippi. This climate generally consists of hot and humid summers with only mild winters. Nashville does, however, receive some snowfall (6.3 inches on average), and it experiences longer seasonal changes than that of Mississippi.

Taxes, at least in the United States, are unavoidable, but in Tennessee, one doesn't have to pay any state income taxes. However, if I were to make $50,000 a year, I can expect a 25% marginal tax rate and an 11.28% effective tax rate for federal income taxes. This would add up to $4,370 under Trump's new tax brackets. FICA would be 7.65%, which would end up at $3,825 dollars. Nashville gets a large majority of its money from property taxes, but I would most likely rent an apartment during my first few years in Nashville, thus avoiding their high real estate taxes. Sales tax in Nashville is a tax I wouldn't be able to avoid, and its rate is 9.25% in Nashville, 7% for the state and 2.25% for Davidson County.

To get around within the city, the county offers numerous parking lots, bus routes, and taxi services. Because I already have my own car, my initial thought is to use my car to move from place to place within the city. On the other hand, the Metro Transit Authority provides bus services that can take me around downtown as well as the airport. I could use this bus service to get to places that are too close to use a car for, especially since I hate looking for parking spots. Depending on if I live downtown, the use of taxis would be a rare occurrence, considering I could walk and use the bus system to get to where I need at a much cheaper price. I'll also consider using a bike if it's convenient enough to get to my office. In 2011, Nashville completed the Music City Bikeway, which added 26 miles of bike lanes throughout the metro area, making it one of the most bike-friendly cities in the South.

Aside from Nashville's strong ties to country music, its health care industries make up most its economy. Currently, twenty-one health care companies are based in Nashville, while a total of 350 health care companies have operations there. The city's payroll spending alone surpasses $4 billion. Because health care is so paramount to the economy of Nashville, it offers extremely good health care for its residents. This is beneficial to me because I can never know when an emergency might occur. Knowing, however, that Nashville offers a copious amount of services, I can be rest assured that I'd be in a good location if an emergency did come up. Aside from music and health care, Nashville is also "the largest publishing center in the Southeast." Thomas Nelson, for example, is a publisher based out of Nashville that produces Bibles for much of the world.

With large cities like Nashville, crime is inevitable. Looking at the crime reports from 1963 to 2017, total crime has taken somewhat of a bell curve. Though the population has increased throughout these years, total crime reached its height in 1996, with 59,533 criminal offenses reported to the police. In 2017, total crime reports decreased to 33,848; however, this is not a complete indication of violent crime. In 2017, Nashville had its highest number of murders (111) and its highest number of rapes since 1993 (568). According to NeighborhoodScout's crime risk analytics, Nashville's crime index is 6 (with 100 being the safest). Relatively unsafe areas are randomly spread throughout the city, so it's hard to determine exactly which areas to stay away from. As one can see, these data points aren't great compared to that of other cities, so I'll have to keep them in the back of my mind.

The Gulch is an area downtown that repeatedly comes up when I look through areas of Nashville, so I decided to use this location to configure an estimate on rental costs.

One such rental property in this area is called the Broadstone Gulch, a high-rise apartment complex. For a 12 month lease, a one bedroom one bath apartment (637 sq ft.) would cost $1,671 per month. Although this is much more expensive that rental properties in Oxford, the downtown experience would be worth the added costs of living. This rental property includes: a rooftop lounge, indoor/outdoor pool, Starbucks coffee bar, office spaces, fitness studio, parking sports, guest suites, laundromats (where I could do my laundry), etc.

Because the Gulch is in downtown Nashville, my commutes would be quite short to any of the firms also located downtown. Depending on which firm, I could potentially ride my bike or drive my car to any other parking garage near the building I'd work in. For example, the distance between the KPMG office and Broadstone Gulch is at most, 8 blocks. That's easily a bike ride away, and it wouldn't take more than 10 minutes. Also located near the Broadstone Gulch is a grocery store called The Turnip Truck Urban Fare, which holds fresh produce and other natural grocery products. Even though this may be more expensive, I'm willing to spend more on healthy food, and potentially cut back on restaurant spending.

One of the most important places for me to find would be a church, preferably nearby, that could heavily invest into. Talking to my parents, they know people who attend First Presbyterian Church Nashville, which is about a 10-15 minute commute from the Gulch. Here, I'd love to find myself involved with a young-adult group that could transition into a friend group for myself, outside of my coworkers. Another organization I could be involved in is Hands On Nashville (HON), a child care facility that prioritizes investing into underprivileged youth in the area. Also, The Nashville Food Project is another large non-profit in town that focuses on growing/cooking food for those who may not be able to obtain enough for themselves or their families.

In general, I love participating in various activities, such as working out, watching sports games, and exploring entertainment venues nearby. On top of my priority list would be CrossFit. It just so happens that there's a CrossFit Music City located right in the Gulch.

Other exciting things about activities in Nashville center around the expanded MLS franchise, which is expected to establish a profession soccer team there in 2020. This would give me a team to cheer for and get excited about, and I'd be there to support them in their beginning years. Outside of sports and fitness, Nashville is mainly known for its music scene. I could seemingly attend concerts every night of the week if I so desired. This is important to me because music has always been a huge part of my life, so having the artists I grew up listening to potentially come through Nashville would give me exciting events to look forward to.

If I did decide to move to Nashville and needed to come home, I'd most likely use my car, since it's less than a six-hour drive. Based on this drive, it'd probably cost me a full tank, which would come out to around $50 conservatively speaking (roundtrip: $100). This wouldn't be difficult at all, and it's one of the many reasons Nashville would be a great option.

Nashville	
Monthly Operating Budget	
Income before taxes	$5,000.00
Federal Income Taxes	$364.17
FICA	$318.75
Rent	$1,671.00
Groceries	$200.00
Car Insurance	$125.00
Health Insurance	$300.00
Discretionary Income	**$2,021.08**
Restaurant/Entertainment	$500.00
Clothing	$100.00
Savings	**$1,421.08**

Attached above is an estimated budget for living in Nashville, assuming that I lived alone and didn't have anyone depending on me, financially. As with life, I'm sure that I am leaving out plenty of possible expenditures; however, this is an estimate of the probable spending I will come across living in Nashville. Though I haven't measured potential spending in NY, I imagine that it would be harder to come up with as much savings as I did looking at Nashville's budget.

New York City

New York City wasn't even a potential location in my mental list of possibilities; however, when Brian Roberson came to speak to us, he completely changed my mind on it. While I originally considered the city high-paced, unforgiving, and over-populated, I quickly realized that it holds tremendous value for my future career. New York is full of opportunities, and its high paced culture will only give me the experience I need to handle any situation going forward in my career. After all, it is the most populated city in the United States, with a population of 8,622,698 people in the city and 20,320,876 people in the metropolitan area.

One personal fear I have regarding New York is the climate; it's not the warm-humid weather I'm used to in the southern state of Mississippi. New York is in the continental climate, with undeniably cold winters and warm to hot summers. This will require a significant adjustment period; however, the snow and whipping winds will quickly become a common occurrence if I decide to live there long enough.

New York City's topography is completely unique. Made up of various regions broken up by the Hudson River, the Long Island Sound, and the New York/New Jersey Bight, it's one of the most complicated, yet highly populated, landmasses in the United States. However, these complex series of islands are made accessible through numerous tunnels, bridges, roads, and subways that allow transportation to flow into, out of, and through the city. This not only adds to the unique personality and history of the city, but it also provides stunning views from any part of the city:

New York is known to be quite expensive to live in. Aside from the standard FICA and Federal Income Taxes, New York poses a state income tax of 6.45%. Obviously, this is higher than that of Nashville, which has no state income tax rate; however, it may be worth it to be able to live in a city as prevalent as New York City. This state income tax would create an added cost of $3,225 a year. Other taxes I'd encounter would be the 8.875% sales tax rate, which is broken up by the city tax of 4.5%, state sales tax of 4%, and a 0.375% surcharge for the Metropolitan Commuter Transportation District surcharge.

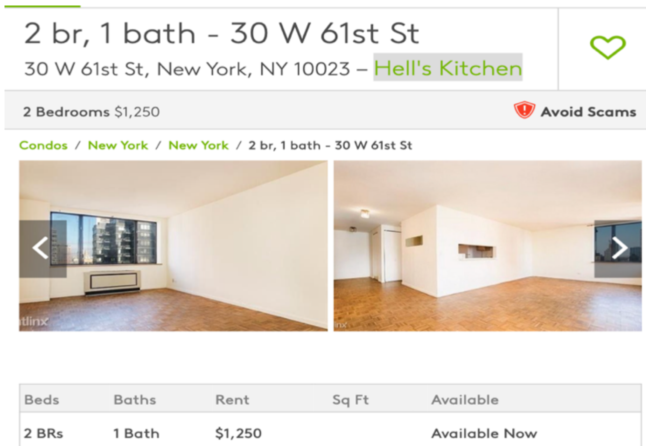
With as many people commuting and visiting New York City every day, they've had to develop numerous transportation hubs to efficiently transport people from place to place within the city. First and foremost are the bright yellow taxis populating the streets throughout the city. Fares in New York start at $3 and then increase on a variable of time and distance. The second mode of transportation is one of 6000 buses running routes throughout the city. These buses cost between $3 and $6, but can be used with Metro cards that can be electronically refilled. The third, and probably most popular, means of travel is through the subway, which also uses the Metro cards for entry.

New York City is packed with various business industries; however, the top two are financial services and health care. Areas like Wall Street are known throughout the world for hosting some of the largest financial services, like that of the New York Stock Exchange. Banks and investment companies line the streets of New York, trying to take their own piece of this profitable industry. Also, when a city has a metropolitan population of twenty million, it can't help but provide health care services in tremendous quantities. These would be two strong industries that accounting firms in NYC would have to provide services for.

Though NYC has a strong industry in health care, its extreme population forces the price of health insurance to be much higher than that of other cities in the United States. However, NYC is researching ways to restructure their health care, even looking at San Francisco as an example to follow. However, this is no guarantee, so if I decided to live there, I'd have to expect elevated premiums on my insurance costs.

New York City has had its moments in history where crimes were especially high. For example, every year from 1969-1995 there were more than 1,000 murders, with a peak of 2,245 murders in 1990. However, since these tumultuous years, NYC has since seen consistent declines in its crime rates. Though crime is still very prevalent, it's not as large of a worry as it was in the past, and I don't believe it's something that will prevent me from wanting to live there.

Known for its high property costs, finding an apartment for a good price would be somewhat challenging. However, I was able to find some studio apartments in the $1,500 range. For example, in Hell's Kitchen (Manhattan), I found a two bedroom, one bath apartment that was available to rent for $1,250. This included furnishing, a deck, and great views. I could easily share this with a roommate, with would cut the cost of rent in half. However, with limited parking and long distances from my home in Mississippi, I don't believe that I would take my car there.



I don't know which office I'll be working at if I do have the chance to work in New York; however, I'll use KPMG's downtown office to estimate a potential commute. From my potential apartment on 30 W 61st St to one of KPMG's downtown offices (in this case their office on 1350 6th Ave), a walk would only be 0.7 miles and take around 15 minutes. This is a great option, and would limit the amount of money I'd spend on my daily commute via subway, bus, or taxi.

Groceries are essential to have food to eat, so finding a store nearby is very important as far as locations go. Westerly Natural Market is in Hell's Kitchen, as well, and it is less than a ten-minute walk from the apartment mentioned earlier. On Google, it has a 4.5 star rating based on 230 reviews, which means that it's well-known and well-respected by locals. Another important essential is a laundromat (in the event that I don't purchase a washing machine and dryer). After searching, I found a Laundromat Café located on 439 W 79th St, which is in Hell's Kitchen, as well.

Similarly stated in my research into Nashville, I'd primarily find myself involved with a nearby church. I discovered a Presbyterian Church nearby on 7 W 55th St. in Manhattan, which is about a 15-minute walk from my apartment in Hell's Kitchen. Here, I'd try to find a group of like-minded individuals that I could spend time with and invest in. Aside from a church, I also found the Harley-House, which serves school-aged youth and provides a community for them. I've always been passionate about investing in those that are younger than me, so this would be extremely fulfilling to me. Another interesting nearby charity is the Miracle House of New York, which gives support and services for people seeking specialized medical treatment who might not get any otherwise. Although I don't have any sort of medical background, I believe my presence and physical support is just as important for those people.

Outside of spiritual and charitable activities are plenty of sports, recreational, and entertainment activities that I could engage in. First and foremost for me would be the New York City Football Club, which is another Major League Soccer team that I could cheer for. Hell's Kitchen also has a CrossFit gym that I could join just right down the street on 315 West 36th St. Working out and staying fit is extremely important to me, so this gym would allow me to continue in that mindset. New York City is a region that is known for its entertainment, so I could enjoy almost any activity that I could think of: concerts, bars, restaurants, shows, etc.

Sadly, because New York City is so far away from Mississippi, getting home wouldn't be some simple commute. It'd require a flight home, which (roundtrip) would cost between $750 and $1,000. This would be hard for me because I've never been an extended distance from my home for a prolonged period; however, because I'd be an adult that's no longer dependent on my parents (for the most part), it wouldn't be as bad of a problem. At the same time, it does make New York a tougher choice.

New York	
Monthly Operating Budget	
Income before taxes	$5,000.00
Federal Income Taxes	$364.17
FICA	$318.75
State Income Taxes	268.75
Rent	$1,250.00
Groceries	$200.00
Transportation	$250
Health Insurance	$300.00
Discretionary Income	**$2,048.33**
Restaurant/Entertainment	$1,000.00
Clothing	$250.00
Savings	**$798.33**

Also, I've attached a simplified operating budget for spending in New York City, which shows increased spending on state income taxes and restaurant/entertainment spending. Though I'd have less savings in the end, I budgeted increased spending on entertainment and eating, which wouldn't be a bad tradeoff.

Conclusion

Based on my research, I found that both cities were still remarkable places to live and work for my first job out of college. Both locations are packed with career opportunities as well as living amenities and activities that I could happily invest my time in. Before I investigated the many components of each city, I thought that I'd end up being much happier with what I found in NYC; however, that wasn't the case. I found that I not only uncovered numerous activities, amenities, and benefits in Nashville, but I also truly enjoyed imagining myself there. Nashville offers an expanded market (bigger than anywhere in MS), while maintaining its Southern culture and feel. Also, investing in the health care industry sounds fascinating for me because I feel like I could spend considerable time serving those in the community. New York showed similar benefits, but it didn't have the charm that I found looking at Nashville. Both cities are still top contenders, and I would be more than excited for the chance to work in either.

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Case 6: WorldCom

Ridge Brohaugh

Dr. Dickinson

16 November 2018

On my honor, I pledge to have neither given, received, nor witnessed any help on this Case.

Ridge Brohaugh

Executive Summary:

In this case, we were given the opportunity to look at the fraudulent accounting behind WorldCom's collapse in 2001. Through a series of questions regarding the nature of assets and expenses, I was able to better understand and defend my knowledge on the ways that various accounting elements make up the business as a whole. For example, assets provide a reflection to the substance of a company (or what that company owns), while expenses show the outflows of value from those assets.

Accounting is paramount to the longevity of any business because it provides the business, as well as shareholders, the public, and the government, with the right details to understand the well-being of the business. At times, fraudulent behaviors can be difficult to see or understand, but they have a large effect on the company as a whole. WorldCom was a business that misstated how it accounted for its costs. Instead of expensing the operational cost of using other companies' lines, they found themselves capitalizing assets that weren't theirs in the first place. Illegal and immoral actions like the one presented in the case, reflect incorrect values for various accounting accounts. If WorldCom had not capitalized their expenses, they would have shown a loss in income for that year. However, among pressure to perform and the desire to keep the value of one's personal assets, people are willing to push the boundaries of morality in order to have what they want.

Understanding the nature of capitalization and how much of an impact it can make was interesting to dive in to. I enjoyed the clarity that GAAP brings about what and how costs should be capitalized. Also, seeing how capitalized costs eventually make their way into the income statement through depreciation and amortization (matching principle), shows the unity that accounting brings.

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

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

Financial statements are pieced together through various financial elements, such as assets, liabilities, equities, investments, revenues, expenses, gains, losses, and more. In accounting, each of these distinct elements are separated by nature through its definitive qualities and its numerical value. For instance, the quantity of assets may be similar to the quantity of liabilities, but because these two elements represent different economic resources, they are unquestionably distinct in their definitive qualities.

Assets are specific financial elements that represent true substance in companies' financial statements. These elements reflect the financial benefits of a company, such as the inventory and equipment owned by a company. According to the FASB Statement of Concepts, assets reflect what companies own, whether it's through obtainment or transaction. With this ownership, companies can describe the nature and amount of future economic benefit, thus providing the government, shareholders, and general public with financial information about the economic status of their company moving forward into the future.

Expenses, like assets, are another example of financial elements that are represented in the financial statements of companies. However, the nature of these elements are quite opposite. Expenses are elements is that they draw the utility out of assets and incur somewhat of a liability. These outflows occur during the use of assets in operations and are an unavoidable cost of doing business.

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

Simply put, costs should be expensed when their future value is spent, meaning that there is no way to retrieve those expenses because their utility has already been used up. Although they provided some sort of benefit, those benefits weren't sustainable and were expensed for that period. On the other hand, costs can directly impact the future value of an asset. In this case, those costs should be capitalized, or added in to the value of the asset. Capitalized costs give assets a specific advantage in the future, which in turn increase the asset's utility. When an assets utility increases, it's worth also increases.

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.**

According to GAAP, the accounting for costs should be matched with the revenues in the period that the costs were used, not when the costs incurred. This is called the matching principle, and it applies even when costs are capitalized. Although the capitalization of costs doesn't go directly into an expense account, these costs are still being recognized. For example, if a company restructured its building and made it more capable in the long run, then that company would incur costs to build that structure. In this case, that structure will provide the company more utility in the future, so those costs need to be capitalized.

This affects the balance sheet by increasing the value of an asset (if capitalized), instead of increasing the company's expense accounts in the income statement. Because these costs are capitalized, their expenses will be expressed in the period in which they were most likely used.

This would take the form of a depreciation expense or an amortization expense, which would be offset against the historical value of the asset. Capitalized costs are moved away from the income statement that year and moved into an asset account on the balance sheet. Over time, when those costs are used, those costs are moved from the balance sheet back into the income statement as an expense during that period.

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

At the end of 2001, WorldCom reported $14,739 million dollars as their line costs for the year. These costs, according to their last report, are access and transport charges. Basically, these are the daily costs of accessing the lines that other companies owned and the costs of shipping materials or goods. The costs to access and transport are operating practices, so capitalizing these expenses would be incorrect reporting according to GAAP. GAAP states that expenses should be capitalized only when the costs will provide a future utility, as stated, "if the amounts being paid out are going to have created a long-lasting asset, then the costs depreciate and can be amortized over several years." These depreciation and amortization accounts allow for a capitalized cost to be recognized in the period that more closely matches the revenue it brought forth during that time. Some long-lasting expenses have utility in following years, so matching all the expenses to one year would not be correct.

In the case of WorldCom, they reported their operating expenses (or the repeating costs to run their business) as capitalized costs, so they weren't matching their expenses in the correct period. They did this so that they could report a lower net income and, therefore, keep their net income looking more profitable than it really was.

Here would be an example of the thousands of line cost journal entries reported in their financial statements:

03/21/2001	Line Expense	$11,500	
	Cash		$11,500
04/22/2001	Line Expense	$15,300	
	Cash		$15,300

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?**

The types of costs that were improperly accounted for are the line costs, which were the costs used to access other companies' lines and to transport materials. So, these costs might occur when the company had to pay other communication companies to use their lines for their own business. Instead of reporting these as expenses in the period that they incurred, WorldCom capitalized these costs, which meant that they were reported in their asset accounts. This is fraudulent because they didn't own these lines that they were accessing, and the costs that match with them are part of their operating practices.

As stated earlier, assets are financial elements that represent the substance of the company or business. In other words, assets reflect what the company owns. In the case of WorldCom, they did not own the lines that they were accessing. When the company capitalized the costs of using those lines, they basically claimed the assets as their own. This, obviously, was not true, and it misstated the elements of their financial statements.

E. **Prepare a single journal entry to record the improperly capitalized line costs of $3.055 billion for the year. Where did these costs appear on the balance sheet? Where on the statement of cash flows?**

Transmission Equipment	$3.055	
Line Cost Expense		$3.055

On the balance sheet, these costs appeared under the Property and Equipment Classification of the Asset section. More specifically, the increase in improperly capitalized line costs was found in the increase in transmission equipment. Also, these costs were shown with an increase in accounts payable and accrued line costs, because these costs were now being capitalized into the value of the transmission equipment. On the statement of cash flows, these costs are not shown until that capitalized asset is expensed through depreciation, which takes time (matching principle).

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.**

First one must take the range of transmission equipment, which has estimated useful lives of 4 to 40 years. The range of this set is 22, so one can assume (based on the instructions) that the useful life of new transmission equipment in 2001 can be calculated with a 22 year life.

Quarter 1: $771 x (4/4) x (1/22*) = $35,045,455 *single-line depreciation

Quarter 2: $610 x (3/4) x (1/22) = $20,795,455

Quarter 3: $743 x (2/4) x (1/22) = $16,886,364

Quarter 4: $931 x (1/4) x (1/22) = $10,579,545

TOTAL: $83, 306,818

Journal Entry:

Depreciation Expense	$83,306,818	
Accumulated Depreciation		$83,306,818

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

Net Income (as stated before taxes)	2,393,000,000
Add: Depreciation Exp	83,306,818
Deduct: Line Cost	3,055,000,000
Loss (Before tax)	(578,693,192)
Estimated Tax Refund	$202,542,617
Net Loss (net of tax)	($376,150,575)

Case 7: Starbucks

Ridge Brohaugh

Dr. Dickinson

4 March 2019

On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this assignment. *Ridge Brohaugh*

Executive Summary:

In this case, we analyzed the financial statements of Starbucks for fiscal year 2013. This is a crucial skill to know and understand as an accountant because we will need to evaluate these statements clearly, in order to perform a legitimate audit when working for an accounting firm. I really enjoyed this case and the various sections of the financial statements that it encouraged you to reflect on.

To start, we were asked to consider the structure of business as a whole for Starbucks, beginning with what type of business Starbucks is as well what sort of structure they have for their financial statements. Once a general overview was established, the case forced us to take a closer look at the actual components of the statements, even developing our own "common-size" statements. These common size statements allowed us to compare sums within the balance sheet and income statement relatively easily by creating a ratio of subcomponents to either the net revenues (income statement) or total assets (balance sheet). This made it simple to pull out information that might otherwise be difficult, such as how the company is proportionally financed or the proportionate make-up of assets and liabilities, whether it be short-term or long-term.

We then evaluated (using the common-size statement) any significant changes from previous year (the statements were consolidated), and looked through the various components of the 10K, including the footnotes and external auditors' opinions. Overall, this was a very practical case that gave me a broader understanding of the financial statements as a whole.

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 money by purchasing coffee beans, brewing them, and selling an assortment of coffee-based drinks to customers who visit their stores. They also sell items such as teas, pastries, and goods (coffee mugs, tea infusers, etc.) to their customers.

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

Basic financial statements in accounting are the balance sheet, income statement, statement of cash flows, and the statement of Equity. In the case of Starbucks, they label these financial statements as the consolidated balance sheet, consolidated statement of earnings, consolidated statement of cash flows, and the consolidated statement of equity, respectively. The definitional answer to what consolidated means is that it combines one or more things into a single, more effective or coherent whole. However, in terms of Starbucks' financial statements, consolidated refers to the fact that these statements provide the finances of more than just one fiscal year. For example, the consolidated balance sheet shows the balances for its accounts from 2013 and 2012.

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

There is a deadline for publicly traded companies to prepare their financial statements. That deadline is 45 days after each quarter end and 90 days after the year end.

So, companies usually take, more or less, 45 days each quarter to prepare these statements (90 days for the year-end).

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

The core of responsibility for financial statements lies in the management of the company providing the financial statements. Once created, a check function needs to be established in order to ensure the validity of these statements. When this check function is needed, companies seek out a third party (accounting firm) to exercise a “check” on these statements. The accounting firm will then prepare an audit on these statements to ensure that what is disclosed is valid and lacking error. These financial statements are incredibly important because it not only showcases the health of a company to the public, but also it shows the growth (or decline) of a business to its investor, signaling company valuation changes. While the public might be interested in overall health/stability, investors look at each piece of information in the statements to determine that current valuation of the company, as well as the potential for future gain. By determining things like interest earned and current ratios, investors can estimate whether or not a company will continue to develop in the future. Other parties who look at these financial statements are the government (check for taxes, etc.) and employees (check to see if the company is withholding more income than they should in terms of higher/lower salaries, etc.)

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 auditors are Deloitte & Touche LLP. These two opinion letters basically determine that the information given in the reported financial statements is validated to be true. In other words, the auditor (Deloitte) has conducted audits based on the Public Company Accounting Oversight Boards and have obtained reasonable assurance to assume the statements are "free of material misstatement." The second opinion says much of the same thing, saying that "in our opinion, the company maintained, in all material respects, effective internal control over financial reporting as of September 29, 2013."

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

Common Size Income Statement

Common Size Income Statement

In Millions, except Per Share data, unless otherwise specified	Sep. 29, 2013	Sep. 30, 2012
Net revenues:		
Company-operated stores	79.19%	79.21%
Licensed stores	9.14%	9.10%
CPG, foodservice and other	11.67%	11.69%
Total net revenues	100.00%	100.00%
Cost of sales including occupancy costs	42.86%	43.71%
Store operating expenses	28.78%	29.46%
Other operating expenses	3.07%	3.23%
Depreciation and amortization expenses	4.17%	4.14%
General and administrative expenses	6.30%	6.02%
Litigation charge	18.70%	0.00%
Total operating expenses	103.87%	86.57%
Gain on sale of properties	0.00%	0.00%
Income from equity investees	1.69%	1.58%
Operating income	-2.19%	15.02%
Interest income and other, net	0.83%	0.71%
Interest expense	-0.19%	-0.25%
Earnings before income taxes	-1.54%	15.48%
Income taxes	-1.60%	5.07%
Net earnings including noncontrolling interests	0.0591%	10.4117%
Net earnings attributable to noncontrolling interest	0.0034%	0.0068%
Net earnings attributable to Starbucks	0.0557%	10.4049%
Earnings per share - basic	0.0001%	0.0138%
Earnings per share - diluted	0.0001%	0.0135%
Weighted average shares outstanding:		
Basic	5.0315%	5.6724%
Diluted	5.1188%	5.8122%
Cash dividends declared per share	0.0060%	0.0054%

Common-Size Balance Sheet

Common Size Balance Sheets (USD $) In Millions, unless otherwise specified	Sep. 29, 2013	Sep. 30, 2012
Current assets:		
Cash and cash equivalents	22.36%	14.46%
Short-term investments	5.71%	10.32%
Accounts receivable, net	4.87%	5.91%
Inventories	9.65%	15.10%
Prepaid expenses and other current assets	2.50%	2.39%
Deferred income taxes, net	2.41%	2.90%
Total current assets	47.51%	51.09%
Long-term investments	0.51%	1.41%
Equity and cost investments	4.31%	5.60%
Property, plant and equipment, net	27.79%	32.35%
Deferred income taxes, net	8.40%	1.18%
Other assets	1.61%	1.76%
Other intangible assets	2.39%	1.75%
Goodwill	7.49%	4.86%
TOTAL ASSETS	100.00%	100.00%
Current liabilities:		
Accounts payable	4.27%	4.84%
Accrued litigation charge	24.17%	0.00%
Accrued liabilities	11.02%	13.79%
Insurance reserves	1.55%	2.04%
Deferred revenue	5.68%	6.21%
Total current liabilities	46.69%	26.89%
Long-term debt	11.28%	6.69%
Other long-term liabilities	3.11%	4.20%
Total liabilities	61.08%	37.77%
Shareholders' equity:		
Common stock ($0.001 par value) - authorized, 1,200.0 shares; issued and outstanding, 753.2 and 749.3 shares (includes 3.4 common stock units), respectively	0.01%	0.01%
Additional paid-in capital	2.45%	0.48%
Retained earnings	35.86%	61.40%
Accumulated other comprehensive income	0.58%	0.28%
Total shareholders' equity	38.90%	62.16%
Noncontrolling interests	0.02%	0.07%
Total equity	38.92%	62.23%
TOTAL LIABILITIES AND EQUITY	100.00%	100.00%

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

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

Assets: $11,516.70 (Millions)

Liabilities: $ 7,034.40

Equity: $ 4,482.30

Assets (11,516.70) = Liabilities + Equity (7,034.40 + 4,482.30)

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

Major Assets are: Cash and Cash equivalents, Inventories, PPE, Deferred Income taxes, Goodwill. Short-term assets are 47.51% of the companies' assets and long-terms assets are 52.49%. These numbers do seem appropriate, considering that most of its sales occur through the distribution of its inventory, while the company also requires large amounts of plant, property, and equipment to distribute their sellable inventories. However, cash and cash equivalents seem higher than I find reason for, double the amount they held in 2012. Although, this could be the cause of foreign exchanges setting up incredibly short-term receivables for stores operating in other countries.

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

In general, intangible assets are assets that may have inherit value, yet lack a physical presence. These assets have value because they represent potential revenue in the future. Goodwill is a long-term asset that is obtained by a business when the value (net of liabilities) of the company they acquire is higher than their purchase price. Intangible assets that Starbucks might specifically have are trademarks, tradenames, trade secrets, patents, copyrights, and acquired rights.

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

Starbucks is financed through equity proportionally higher than that of debt. While the long-term debt (non-owners) proportion of total liabilities and equities is 11.28%, the total shareholders' equity (owners) is 38.90%.

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?

From a company-operated store perspective, revenues are recognized when "payment is tendered," or when the customer pays Starbucks for the services they've either given or are going to give while they are present in the store. These services are carried out approximately the same time that the cash is being paid, but because revenue is recognized based on the cash payment, they use a cash basis method in their company-operated stores. On the other hand, when determining licensed store revenues, Starbucks recognizes revenue when the actual products are shipped to licenses, which is when the service is provided, not the cash paid. In this aspect of revenue, Starbucks uses accrual accounting. When it comes to stored value cards, Starbucks recognizes the revenue when the cards are redeemed or when the statistical likelihood of the redemption passes. In the case that redemption is deemed remote (there are no expiration dates), those outstanding balances are included in deferred revenue on the consolidated balance sheets.

ii. What are Starbucks' major expenses?

Starbucks' typically has two major expenses: Cost of sales including occupancy costs and store operating expenses. These expenses consist of the actual cost of inventory (including coffee, milk, tea, sweeteners, cups, etc.) as well as the costs included in operating the stores (rent, employee wages, electricity, etc.). These expenses aren't uncommon to businesses like Starbucks; however, in 2013, Starbucks faced a litigation charge that cost them 18.7% of their total revenues. This was the cause of a discontinued contract dispute with Kraft Food Groups in March of 2011.

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

Cost structures for business don't necessarily change over time, unless they move into different industries. In the case of Starbucks, their cost structure was forced to change. This variation was the onset of a litigation charge that paid Kraft Food Groups $2.78 Billion dollars. So, yes, there was a significant change in the cost structure of Starbucks in 2013, and the change caused their earnings before tax to actually be negative.

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?

Starbucks wanted to clearly label the $2.78 Billion dollar increase from its litigation expense so that investors didn't think that the numbers were due to increased operating costs that would be extended or reoccurring in the future. This large charge was filed in 2013, and that same charge would not occur again in the future, so placing it in general and administrative expenses would increase the account for that year (2013) in an unbalanced manner.

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

To start, my definition of "profitable" is in terms of actual business profits. What I mean by that is that for me to consider a company profitable, it needs to have a positive earning before taxes are considered. I specify this because I believe that, in 2013, Starbucks was not profitable. According to their statement of earnings, Starbucks was $230 million dollars under before taxes were considered. Compared to the $2.06 billion-dollar EBT in 2012, I'd say that Starbucks was unprofitable that year. However, to be technical, the government gave Starbucks a tax rebate of $239 million dollars. This brought Starbucks back over the line with net earnings attributable to Starbucks at $8.3 million dollars, which made them "profitable" for that year, even if it was significantly less profits than the previous year.

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

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

The net earnings for Starbucks in 2013 were significantly less than the cash inflow from operating activities. While Net Earnings equates to $8.8 million dollars, the Net Cash provided by operating activities equates to $2.9 Billion dollars. Most of this difference is because of the large adjustment to reconcile net earnings to net cash from its litigation charge with Kraft Foods.

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

During fiscal year 2013, Starbucks paid out a total of $2.5 Billion dollars on plant, property and equipment. However, they also received $1.1 Billion dollars from their previous investments. This totals their net cash used by investing activities to around $1.4 Billion 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?**

In 2013, Cash Dividends Paid equaled $628.9 million dollars, while the Statement of Equity shows that the Cash dividend account totals $668.8 million dollars. The difference between the two accounts is the dividends payable, or the cash dividends accrued, but not yet paid.

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

Because of GAAP, preparing financial statements requires the use of estimates and assumptions for accounts such as good-will impairment, stock-based compensation forfeiture rates, future asset retirement obligations, and inventory reserves. Other accounts pertain to self-insurance reserves and income from unredeemed stored value cards, potential outcome of future tax consequences of events. However, there are accounts that are still estimate free, such as cash dividends, Common stock outstanding, accounts receivable, cash, etc.

Ridge Brohaugh

Dr. Dickinson

Case 8: BP

3 April 2019

Honor's Statement: "On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this assignment" *-Ridge Brohaugh*

Executive Summary:

In this case, we looked into the BP Deepwater Horizon oil spill in order to evaluate the various components of contingent liabilities and contingent assets. We first established the definition of each of these, and we developed examples of when companies would record contingent liabilities versus when they would record contingent assets. While both are recorded when the possibility of occurrence is probable and the potential for estimation is present, contingent liabilities reflect a future outflow of economic resources while contingent assets portray probable future economic benefits. The difference of accounting between the two, other than the fact that one is a liability and the other is an asset, is that the liability is reported fully in a company's financial statements, while the assets are typically disclosed in the notes. The reason GAAP requires this is because of the conservatism principle, which attempts to keep accounting understated as opposed to overstated (overstated estimates can be dangerous to both the company and its investors).

We then looked into product warranties, which are an example of contingent liabilities (or assets – depending on the transaction point-of-view), and lawsuits. In the case of the oil spill, BP will most likely pay (outflow of economic resources) immense costs in order to remove the damaged machinery, clean the oil from the surrounding areas, and face numerous battles in court. Overall, contingent liabilities (or assets) are important to the financial statements of any company, and their function is more than to state measurements that have yet to occur. As a whole, contingencies give companies the freedom the ability to provide investors with the best financial representation possible.

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

A contingent liability is a potential debt that could be owed, depending on future circumstances or events. These contingent liabilities can occur for a number of reasons, such as lawsuits and product obligations, and it's important/required for companies to be aware of these potential liabilities. If liabilities are probable and estimable, companies must report them in their financial statements. An example of this would be if a company was caught mishandling its chemical waste, and the company found itself likely to be involved in a lawsuit. Although money for the lawsuit is not currently owed, it's likely to be owed at some point in the future, so the company should not ignore the contingent liability it is facing. Instead, the company should report the liability for the amount that is estimable, thus better reflecting the true nature of its balance sheet. Other types of contingent liabilities include government investigations, expropriations, and warranties.

Contingencies, however, don't always have to be liabilities. In fact, there are contingencies that positively affect the financial statements of companies. These contingencies are called contingent assets, which represent future gains, depending on a future outcome or event. Examples of contingent assets (gains) include compensation lawsuits or possible benefits such as estate, tax, etc. Companies do, often times, record these contingent assets; however, according GAAP, these contingent assets should be disclosed in the notes because they are potential gains. The conservatism principles required GAAP force companies to report gains with a perspective that it might not occur, thus eliminating inflated finances.

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?**

The purchaser (BP in this case) of a product with a product warranty generally considers the warranty to be a contingency asset; however, from the seller's point of view (GE Oil and Gas), the warranty of a product is recognized as a contingent liability. From the purchaser's perspective, a product warranty is a guarantee, made by the manufacturer, that the product works, and if it doesn't, the manufacturer or vendor will replace it either for free or with discounted charges. This gain, however, should only be disclosed in the notes of the financial statements (conservatism).

From the point of view of the seller/manufacturer, warranties are considered contingent liabilities because warranties represent future potential obligation, depending on the quality of the service or product already provided. These future potential obligations typically come at the cost of the manufacturer or vendor, meaning that it's a liability representing future loss. So, in the case of GE Oil and Gas, a warranty on their telescopic joint product represents their obligation to pay, restore, or refund their product in order to assure their customers that they will receive what they expect to receive.

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?

As far as management judgement, warranties need to go under scrutiny for two main elements: estimation and probability. So, in order to determine how to account for warranties, management must decide the extent/magnitude of each of those elements. For example, accrued warranty costs might have an allowance for the estimable amount of warranty costs based on the probability of returns. In the case for the Deepwater Horizon oil spill, however, both estimation of costs and probability of various lawsuits/further damage is not easily determinable, so it's not as simple as determining the warranty claim on a product, such as a telescopic joint.

Instead, companies must do extensive research in order to determine an amount on the warranty that is both estimable and probable for the effects of their oil spill. In the case of BP, they labeled their contingent liabilities from the Deepwater Horizon Oil Spill as "Provisions," which they claimed were present obligations recognizing a probable outflow of resources in order to settle obligations. These provisions, according to their condensed group cash flow statement, showed an "net charge for provisions" at $16.4 billion dollar (the year prior was only $0.2 billion dollars.

D. Describe some of the estimates that BP must make to account for the contingencies associated with the Deepwater Horizon oil spill. By way of comparison, the Exxon Valdez oil spill took place on March 24, 1989. Litigation continues as of early 2011. If you were an auditor for BP, how would you draw a boundary with the potential losses. Think of an extensive list of all the people that could so, and whether or not that is reasonable.

Contingent liabilities can be made up of numerous estimates, depending on the extent of the potential liability on hand. In the case of the Deepwater Horizon oil spill, estimates are largely going to comprise of clean-up expenses (oil, rig, water, land, etc.), lawsuits (governmental, possibly criminal, injury/death), and losses (from company devaluations and lost sales). These contingencies, like that of the Exxon Valdez oil spill, will continue to be present for many years, and each year, new estimations and probabilities will need to be calculated. The question then becomes, who calculates these contingencies and how do they provide some sort of boundary for the potential losses?

To start, the auditor holds the ultimate responsibility to ensure that the potential contingency losses are reflected as genuinely as possible, given the amount of information. However, outside of the auditor, there needs to be many people involved in making the numerous financial estimations that make up the final appraisal. For example, if the auditor was trying to reflect the potential costs of future lawsuits, he or she may need to consult many different lawyers, who are capable of calculating the potential costs of litigations, as well as the probability that those litigations will require compensation. Another person who could be involved in this estimation could be environmental scientists or groups of scientists, who can calculate the damaging costs of the oil spill. Also, the auditor might need to contact certain engineers, who can estimate the costs of destroyed equipment, as well as the costs to move the broken machinery back to land.

There are, quite possibly, dozens of more people who could be involved in calculating the boundary of a contingent liability like that of an oil spill; however, in regards to the auditor's role, he or she (or the group) should determine was is currently probable/estimable that year, and then reflect potential long term-liabilities in the non-current liability section. Then, as those long-term liabilities become more relevant, better estimates can then be calculated to provide a reasonable estimate.

Ridge Brohaugh

Dr. Dickinson

Case 9: Wendy's

10 April 2019

Honor's Statement: "On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this assignment" *-Ridge Brohaugh*

Executive Summary:

In this case, we used the financial statements of Wendy's to take a closer look at the various components of the equity method of accounting. The equity method is used when investors hold more than 20% interest in a company, and they possess significant influence over the operating and financial policies of the investee. Because of the substantive relationship between the investor and the investee under the equity method, investors report the proportionate share of earnings and losses each period. For example, if Wendy's owned 40% of an investee and that investee reported $1,000,000 in income that year, then Wendy's would record an "Equity Investment" debit of $40,000 and a credit to "Investment Income" for 400,000. The same.

Aside from income, we also looked at the valuation of assets in a transaction. We found that often times, investors pay more than the book value of net assets that the investee reports. In this case, the investor would first mark up the individual assets and liabilities to fair value. Then, whatever amount is leftover is contributed to the "Goodwill" account, which reflects the value of the intangible assets that the investee possesses.

By looking at the "Notes to Consolidated Financial Statements," we were actually able to reconcile certain accounts in order to understand how Wendy's actually computed them each year. For example, we looked at how their equity investments affected earnings before income in the income statement, and we also analyzed certain adjustment values in the statement of cash flows.

Overall, this case prepared me to evaluate financial statements more effectively, as well as how to understand the interconnectedness of relationships between different accounts.

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

Joint ventures occur when two companies combine their resources in order to create an entirely new entity. Usually, companies enter joint ventures when both parties are looking to complete a common goal or specific task. Sometimes companies need more resources than they currently have in order to complete these tasks, so two (or more) companies combine their individual resources so that they can mutually benefit from the new entities' capacities. Joint ventures, however, are not limited to the completion of projects or tasks. For example, they can be used to tap into markets that the companies have been unable to otherwise or foster new skills and capabilities for their employees.

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.

When an investor, such as Wendy's, holds interest of more than 20% in an investee, they (most often) possess significant influence over the operating and financial policies of that investee. By accounting for an investor's interest in an investee using the equity method, both parties are acknowledging that a substantive economic relationship exists between each other. This somewhat codependent relationship is thus reflected in the investor's financial statements. Under the equity method, the investor reports their proportionate share of the earnings and losses of the investee through the investment's carrying amount.

To elaborate, when a company invests a certain sum into an investee (more than 20% interest), the original investment is reflected through an "Equity Investment (Dr.)" account in the amount that was invested (credit to cash). When that investee reports net income (loss), the proportionate share (based on the percentage of interest in the company) of that income (loss) increases (or decreases) the “Equity Investment” account. In the case of net income, the investor will credit “Investment Income” in the same journal entry.

Aside from income, equity method also evaluates the distribution of dividends. When the investee distributes cash dividends, that cash per share is debited to the investor for the number of proportionate shares that they own. However, because cash dividends reflect a decrease in assets for the investee, the investor needs to account for this loss in overall value for their investment in the investee. So, the journal entry that debits cash would be offset by a credit to the “Equity Investment” for that same amount.

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

When a company purchases shares in another company for more than the book value of the underlying net assets (assets – liabilities), those assets and liabilities must first be reevaluated. When a transaction is made, the assets and liabilities must be marked up (or down) to their true fair value, so it makes sense that in an investment, there is a difference between net book value of assets/liabilities and the total transaction price (acquisition accounting premium). However, often times, after the net assets have been brought up to the fair value price, there still remain a difference in the value and transaction price. This difference is termed “goodwill,” and it represents value in the company that might not necessarily come from tangible assets, such as the brand name or customer base. This difference is thus accounted for under the equity method, and in the future, there is a yearly test for impairment on the value of the company’s 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?

As far as equity investments, Wendy's included the year end carrying values of both Tim Horton's Inc and Japan Joint Venture for 2011 and 2012. These are included under Wendy's consolidated balance sheet under "Investments". However, under the consolidated balance sheet show that the investment account for the year ended 2012 has a balance of $113,283 (in thousands), while the total investment cost (at year end 2012) for all of Wendy's investments is $111,533. The $1,750 difference was determined because Wendy's included their equity investment in Japan's joint venture in "Other Liabilities" in the same balance sheet. Wendy's stated the investment in their liabilities section because they have promised to finance any future cash needs that the Japan JV may have.

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?

In Note 8, the amount recorded under the "Joint Venture with THI" is $89,370. However, to calculate TimWen's 50% share under the equity method, one would need to subtract the $54,088 difference due to purchase price adjustments. This gives a total AAP (acquisition accounting premium) of $35,282, which constitutes both the goodwill and the writeups upon acquisition.

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

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

Wendy's investment under the equity method affects their earnings before taxes in 2012 and 2011 through the net operating expenses. Referring to Note 8, Wendy's shows "Equity in Earnings for the period" for $13,680 and $13,505 for 2012 and 2011, respectively. These earnings, as well as the amortization adjustment for purchase price, decreased the earnings before cash. In 2012 (2011), the "Equity in Earnings" was $13,680 ($13,505), while the "Amortization of the Purchase Price Adjustment" was $3,129 ($2,934). The difference of $10,551 (10,571) represents the change in income before taxes.

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

12/31/12

Equity Investments	$13,680	
Investment 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.**

In 2012, the amortization of the purchase price is shown to be $3,129, which will be deducted from the equity in earnings. This amortization will be accounted for over the course of its life of 21 years.

12/31/12

Loss on Investment	$3,129	
Equity Investment		$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.

Wendy's received $15,274 in dividends in 2012 and $14,942 in dividends in 2011. The journal entry to record this receipt of dividends in 2012 is as follows:

12/31/12

Cash	$15,274	
Equity Investment		$15,274

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

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

To understand the adjustment, the company first has to compute the total "Equity in Earnings in Joint Ventures, Net" for both Tim Horton's as well as that of the Japan joint venture. In 2012, Wendy's portion of Tim Horton's earnings was $10,551, and their portion of Japan's joint venture was ($1,827). The combined value of these earnings equals $8,724, which represents income; however, it does not reflect cash inflow. Therefore, the net total of "Equity in

Earnings in Joint Ventures, Net" is a negative adjustment of ($8,274) to arrive at net cash from operating activities.

ii. **The operating section also reports a positive adjustment for "Distributions Received from Joint Venture" of $15,274 in 2012. Reconcile this amount to the information disclosed in Note 8. Explain why a positive adjustment is made to arrive at net cash from operating activities.**

A positive adjustment is made to arrive at net cash from operating activities because this adjustment for "Distributions Received from Joint Venture" represents a cash dividend receipt. Although cash dividends decrease the value of the equity investment, the entry for this event debits cash. Thus, $15,274 shows an increase in cash flow for the period ending December 30, 2012.

Johnson & Johnson

Case 10

Ridge Brohaugh

Dr. Dickinson

19 April 2019

Honor's Statement: "On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this assignment" *-Ridge Brohaugh*

Executive Summary:

In this case, we considered the various aspects of pension funds. We started by understanding the two major types of pension funds: defined benefit plans and defined contribution plans. Most of the case, however, we analyzed the components of a defined benefit plan, which defines a set contribution for an employee's services at a later date. Because of the many factors involved in the value of money at a long-term date, many calculations and assumptions need to be made in order to provide accurate information on the obligation to be paid and the amount of plan assets that have been funded each period.

By using the financial statements of Johnson & Johnson, we were able to see the manner in which they reported these liabilities. By using accounts such as "employee related obligations," we were able to see how the compute the pension expense on a period by period basis. We were also able to see how the various journal entries and estimations involved in calculating the pension expense affected the different financial statements. For example, we calculated the interest expense in 2007 by dividing the interest cost for a certain period and dividing it by the beginning balance of the projected benefit obligation.

By looking at the financial statements and analyzing its various components, we were able to better grasp an understanding of how companies keep up with this extremely costly obligation. Honestly, this was one of my favorite cases because its involvement in the financial statements is directly correlated to the theoretical principles we've learned in our intermediate class. This case not only refined what I know from a scholarly perspective, but it gave me applications that allowed me to think deeply about the subject of pensions.

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?

Defined benefit plans and defined contribution plans are both pension plans that pay their employees at a later date; however, these retirement plans differ in their approach towards that end payment. In a defined contribution plan, the employer agrees to contribute a predetermined amount towards an employee's pension benefit. This type of benefit minimizes the risk that the employer holds because the employer doesn't have a defined ultimate payment. On the other hand, in a defined benefit plan, the employer defines the ultimate benefit paid to the employee at the end of their years of service. In this pension plan, the employer holds the most risk because it's difficult to predict the amount of funding needed to pay the ultimate benefit and the end of each employee's service years.

ii. Explain why retirement plan obligations are liabilities.

Retirement plan obligations are liabilities because they represent future economic obligations for an employer's past (and future) events. To be more specific, pension plans define an amount that the employer is expected to pay their employees at a future date. Companies need to identify these plans as liabilities because pension plans make up such a large amount of funds to be paid off in the future. If companies didn't report these as liabilities, then their assets would be overstated because they would have failed to recognize the funds needed to pay off their future obligations.

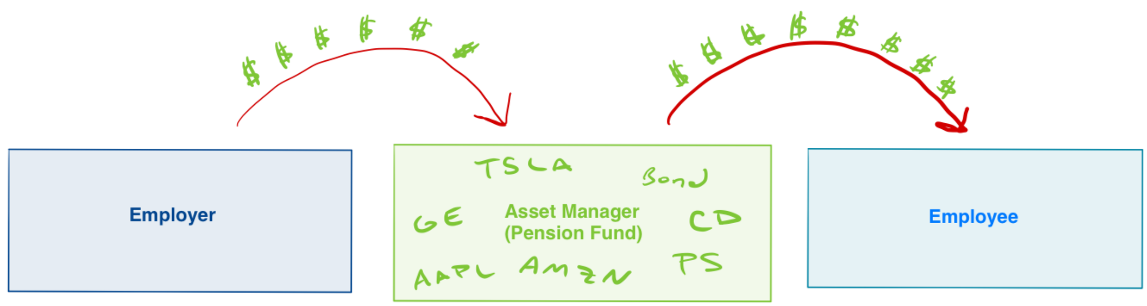

Diagram to illustrate parties involved in a pension fund.

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

When estimating retirement plan obligations, companies have to take the time to develop estimations for these contributions because there are many changes occur over time that can change the ultimate approximation significantly. The assumptions need to be taken into account in order to provide the most reliable estimate possible. Examples of these assumptions include the plan asset's expected return, service times of the employees, vested and non-vested benefits, mortality rates, employee turnover, interest and earnings rates, retirement frequency, future salaries, and many other factors that affect the measurement of the pension plan.

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.

When employers calculate pension expense (the amount to be expensed towards the pension obligation), they total the amount of service cost, interest cost, gains/losses, and benefits paid that financial period. Service costs are the present value benefits accrued for the service that each employee contributed that period. When calculating this cost, however, companies must consider the future salaries of these employees, and determine the present value of the benefits using the years-of-service method. This method determines the amount of service years the company expects an employee to work and then determines the service cost for each year of service contributed by the employee.

Besides service costs, interest costs expense the interest accumulated on the liability (planned benefit obligation) that year. This accrued calculation is necessary because each year the company defers the liability for the pension until it matures. By calculating the interest expense, the company matches the interest accrued with the period, so that in the end, the interest expense won't be a large accumulated sum over a large period of time.

Actuarial gains/losses also need to be determined in order to calculate pension expense for the year. These gains and losses usually occur for two reasons: sudden and large changes in the fair value of the plan assets and changes in actuarial assumptions. Both of these events change the calculated amount of planned benefit obligation that the company will need to pay off. Plan assets change their fair value when the actual return on plan assets are different than the estimated. The difference between the actual and estimated return changes the amount of obligation the company is expected to pay in the end because the obligation will be paid off with these plan assets. If the plan assets increase in value, the company wouldn't have to contribute as much in order to match the defined benefit obligation set up. Actuarial assumptions also change, and these occur when actuaries reconfigure their original estimate due to environment/social changes, such as employees working more years than previously thought.

Finally, benefits paid to retirees represent the decrease in plan assets, as well as the planned benefit obligation. This occurs when the employee receives his/her pension, and the liability expected to be paid off is actually paid off. This decreases the obligation that the company owes in the future, and it decreases the account for both plan assets and pension obligations.

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

Pension assets are also affected by various activities. To start, actual returns on pension investments occur when the return on investments that the plan assets make each period. These returns include figures such as interest receivable, dividends, and realized/unrealized changes in the fair value of the plan assets. The formula for the actual return is set up as:

$$\text{Actual Return} = \left(\begin{array}{l}\text{Plan}\\\text{Assets}\\\text{Ending}\\\text{Balance}\end{array} - \begin{array}{l}\text{Plan}\\\text{Assets}\\\text{Beginning}\\\text{Balance}\end{array}\right) - (\text{Contributions} - \text{Benefits Paid})$$

Other activity changes that affect pension assets include company contributions (included in the formula). Contributions made by the employee (through the crediting of cash) increase the amount of funds allocated to the plan assets, and thus, increase the fair value of the plan asset by the amount of cash contributed.

This contribution is offset by the amount of benefits paid to retirees, as shown in the formula, as well. These benefits paid are the actual distribution of benefits to the employees, and thus, decrease the amount of funds in the plan assets account. As stated earlier, benefits paid decrease the amount of future obligation, because they are a decrease in current assets (plan assets) for the current period.

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.

As stated, assumptions on expected returns rarely equate to the actual return on plan assets. Because the calculations for pension expense are based on expected returns, companies need to adjust for the actual return, when the actual return significantly varies from the expected. The difference between actual and expected return can increase/decrease because of fluctuations in the market that are uncontrollable, such as company values, macroeconomic changes, interest rate changes, etc.

When these differences are significant and need to be adjusted, companies utilize the "corridor approach," which smooths the difference between expected and actual return on plan assets. To use this approach, companies must first calculate 10% of the larger of the beginning balances between projected benefit obligation and the value of plan assets. Any gains/losses in excess of that 10% threshold must be amortized to the value of the plan asset so that the plan assets can better reflect the fair value, without fully chasing the volatile value each period.

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?

OMIT

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

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

Johnson & Johnson recorded $646 million as its pension expense for 2007.

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

Journal entry for the pension expense:

Dec 31. 2007		
Service Cost Expense	$597	
Interest Expense	$656	
Present Benefit Obligation		$1,253

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

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

At December 31, 2007, the value of the company's retirement plan obligation is $12,002 million dollars. This value represent the projected (or estimated) value that the company has given, and it is a reliable number based on numerous assumptions. However, this valuation is not a perfect reflection of the actual change in benefit obligation, so it should be compared to the recalculated obligation each year.

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

The pension related interest cost for the year is $656 million dollars. By dividing this cost by the beginning balance of the projected benefit obligation, one can compute an interest rate of 5.62%. This rate is reasonable because it reflects a similar rate that the company uses as its discount rate (6.5%).

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

The amount of pension benefits paid to retirees during the year was $481 million dollars. The company does not pay cash for these benefits paid because it represents a distribution of plan assets, not cash. Cash is credited from the company when it pays into the plan assets; however, when the company receives benefits, those benefits are received from the plan assets. This payment not only decreases the plan assets, but it also decreases the future obligations of the company (projected benefit obligation).

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

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

The value of the plan assets held by Johnson & Johnson on December 31, 2007 was $10,469 million dollars. This value represents the accumulated fair value of the actual returns, company contributions, participant contributions, settlements, divestures, benefits paid, and exchange rate changes. This total value is the fair value of asset in the plan assets, such as equity and debt securities.

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

The amount of expected return was 9% of the beginning fair value of the plan value, which calculates to be $858.42 million dollars. However, the actual return showed $743 million dollars, which is a difference of $115.42 million dollars. I believe that this difference is close but not quite significant because it stays within the corridor amount. By taking 10% of the larger beginning balances between the benefit obligation and plan assets, you calculate a corridor amount of $116 million, which is slightly more than the difference in expected values. I believe that the actual return provides a better reflection of the pension expense because the decreased value in the return increases the pension expense, which better reflects the added obligation needed to fill the decreased expectation of returns on the plan assets.

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

In 2007 Johnson & Johnson contributed $317 million, and in 2006 it contributed $259 million (a $58 million dollar difference).

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

Johnson & Johnson's allocates their plan assets into two major investments: equity securities and debt securities. In 2007, the company had 79% of their plan assets allocated to equity securities and 21% allocated to debt securities. In terms of equity securities, the fair value of Johnson & Johnson common stock held in their plan assets was $462 million (4.4% of total assets) at December 30, 2007.

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?

On December 31, 2007, Johnson & Johnson's pension plan is underfunded by $1,533 million, and on December 31, 2006, the company's pension plan is underfunded by $2,122 million. Looking at the consolidated balance sheet, these funded amounts are located under the account titled "Employee related obligations (Note 5 and 13)." More specifically, note 13 specifically states that a portion of the employee related obligations are due to pensions and other benefit plans that Johnson & Johnson has committed to pay in the future.

Ridge Brohaugh

Dr. Dickinson

Case 11: Income Statement

26 April 2019

I. Summary

In this paper, the authors give a detailed argument on the supremacy of the income statement approach to accounting over that of the balance sheet approach. To start, the authors introduce an overview of the current model for financial reporting. They quickly point out that over the past 30 years, the balance sheet-based model of accounting has grown and solidified into the unified standard it is today. Thanks to boards such as the FASB and the IASB, accounting has become quite standardized across many borders and regions. With this in mind, the landscape of business has become increasingly subject to and impacted by changes within the boards' framework. Because changes in standards have such significant impacts, the foundations that the accounting framework is set upon needs to be reflective of the true nature of business. After all, the foundation of a standards framework has the power to "impact the state of financial reporting for decades to come."

Once the authors thoroughly detailed the importance of a firm foundation in accounting, they began to provide their readers with an overview of the current foundation of accounting – the balance sheet. The balance sheet approach to financial reporting views the balance sheet as a measure of change in the valuation of assets and liabilities. From this perspective, any financial determinations are thus derived straight from the balance sheet. For example, when calculating the income statement, one could claim that the income statement is the direct changes in net assets and liabilities over that particular period.

The authors provide a detailed look in to the history of accountancy, and they claim that the original foundation was, in fact, the income statement view of financial reporting. Up until the beginning of the FASB in 1973, the principles/theories behind the accounting practices of the time attempted to track and record the various revenues, expenses, and earnings each period. At the same time, accounting principles held that the overall assets and liabilities of a company provided only a secondary perspective to the true nature of an individual business. However, when the FASB began the daunting task of standardizing the accounting practices of the United States (and beyond), they needed to take time to develop a sound framework to hold as a workable foundation.

The FASB chose to develop a balance sheet approach as the cornerstone of the standard setting. This decision was made because the Board concluded that the balance sheet is the only "logical and conceptually sound basis of accounting." They came to this conclusion after deciding that the only way to accurately report financial statements is to clearly define what "value" is, and what it is derived from. At the time, a change in value could be best described as changes in the assets of a company and the future economic obligations they owed in the future. From then, the standards set in accounting have become increasingly polarized along the idea of the balance sheet approach, including initiatives such as "fair value" accounting. The authors go so far as to say that the current views shy away from language such as "revenues", "expenses", "earnings", and "income," preferring instead to use terms such as "changes in economic resources and claims to them."

This perspective, as pointed out by the authors, is increasingly troubling given the nature of businesses today. While the balance sheets give priority to companies' assets, businesses aren't in operation to increase the value of their assets. Instead, companies sacrifice their assets (expenses) in order to make an economic gain (revenues), and they don't have their business value tied only to the assets that they possess. The best argument for this concept is that of the "asset greenhouse" associated with the balance-sheet approach, and that of the "asset furnace" connected to the income statement approach. The authors give a metaphor to the balance-sheet approach by reimagining firms as “asset greenhouses.” These “greenhouses” look to grow the assets they have each period, and thus, their earnings are simply the combination of realized and unrealized growth of these assets.

Most businesses, however, don’t utilize their assets in this fashion. Instead, the authors claim that companies are more like assets furnaces in that they “burn” assets each period in order to produce revenues and earnings. The paper then goes in to the example of a Middle Age guild, whose partners somewhat rent resources in order to make profits, an example being the rental of a ship and crew for the completion of a larger mission. In this case, what’s important each mission or period is “the expenses advanced, and the revenue and profits ultimately earned.”

Over time, the cumulated income statements can give a clear value of the company as a whole, and it does not have to be reflected through the static assets that the company owns. Investors, for instance, utilize the earnings much more than that of the balance sheet in order to determine a clear value of their investments. Strangely, the FASB states that their most important users to companies’ financial statements are investors, even though the FASB pushes a strong balance sheet agenda. The authors are obviously frustrated because the balance sheet “is largely silent about the notions of business model and business performance, which are central to a firm’s success and value-creation.”

The authors try to illustrate this argument even more by providing empirical evidence on the utilization of PPE in companies over the last 15 years. From their tables, one can see that the use of PPE for internal purposes exceeds the use of PPE for external purposes by a “magnitude of 5 to 10 times.” In this example, PPE is not being used to grow more assets, instead it’s used as an expense (burn) each period in order to sacrifice for a large stream of revenue. The company, in this case, should not be valued by its PPE (which is typically one of the largest accounts for companies); it should, instead, be valued at the amount of earnings it can make on its various assets.

The authors are extremely clear that the financial statements should be more reflective of the earnings each period and less focused on the overall assets that a company's own. After all, the idea of assets in modern companies has become increasingly more intangible and complex. For example, Microsoft owns many assets; however, these assets are not the direct link and causation of Microsoft's incredible profitability. Instead of attempting to value these assets with strange accounts such as intangibles or goodwill or human capital, etc., companies should first prioritize the earnings that a company brings in. In today's world of business, "assets are elusive conceptually and difficult to operationalize in any helpful way."

According the income-statement approach, the most important calculation and number for the firms is their earnings, and because of this, investors need better metrics in which to evaluate these calculations. By prioritizing the income statement over the balance sheet, companies and investors are better able to evaluate businesses based on various variables and determinants. With this, investors are able to make better decisions on their investments and accurately price stocks according to their value. The authors understand that securities in the markets aren't always a true reflection of the value of a company. Market bubbles have and will continue to occur, especially when the accounting framework allows assets to be marked at its fair value. The authors see this deviation as dangerous, stating that accounting "needs to reflect their real economy activities, and provide inputs and independent checks on the valuation and trading process in financial markets.

For the authors' final push, they elaborate on the importance of clarity and for the emphasis on both the matching principle and the revenue recognition principle. Following the economic logic of businesses, matching and revenue recognition clearly follow the true nature of how businesses run from a period by period basis, and so, financial reporting should also clearly report these principles because understanding the match-up between earnings and the expenses to create those earnings (outside of time) is important to understanding the amount of value a company is capable of bringing in in the future.

II. How did reading this article change your current way of thinking?

To start, this article opened my eyes to the idea that accounting measures can be reflected in a multitude of ways. As a student in the process of learning the various principles and methodology of accounting, it's difficult not to internalize accounting as only working in one (or maybe two) ways. While learning, we are told how various financial measurements are derived, and why we account for those measurements in the way that we do. Although this is the way we're taught, we shouldn't believe that accounting, in its nature, can only be calculated in one direction. This paper showed me that accounting is much more complicated than that – why else would we need such strict standards, after all?

Accounting and its principles can be looked at from a multitude of perspectives, and it should be reflective of the truest nature of business. I've never visualized the manner in which business is run better than I have with the metaphor of the "asset furnace," and it is such a great example of challenging the perspectives that we've internalized (without always even realizing it). I've never thought that businesses could be valued in any other way, other than that of its overall assets minus overall obligations. While this is definitely an accurate way to do so, companies can also be evaluated on its ability to produce revenues on its assets. In this paper, the authors use Microsoft as a perfect example to this. While Microsoft may have similar assets to that of other high-tech companies in the world, the value of brand recognition and software development has given Microsoft a significantly different overall value than that of companies with similar assets.

As students, we should be responsible for learning the current methodologies applied in the world of financial reporting, but we should also understand that our overall objective is to reflect businesses in its truest manner. Because standards are created by humans, there will continue to be flaws and shortcomings in how the value is derived. We should never neglect the possibility of a better method of reflection, especially with the changing nature of business in this post-modern landscape of the world.

Another way that the article changed my current thought process (for reasons more than just accounting) was in the importance of a foundation for any standard that is put into effect. In this paper, the authors were attempting to convince the Board to change the foundation that the current principles are placed upon. The authors wanted a foundation based on the income statements, where the current foundation is the balance sheet. This is interesting to me because it forces me to consider the reason that companies (or anyone/anything) have the practices and principles that they do in their decision making. Any time a decision is made, it's made with the intention to follow a larger goal that the person/company is trying to follow. Whether its stated or not, these larger goals have an agenda, and it's important to understand what that agenda is.

Take for example a companies' decision to use a certain fuel that may be slightly less expensive, but it is much more pollutant to the air/environment. This company, as deduced from this one decision, is showing that they (most likely) value profits more than that of the preservation of the surrounding environment. This company's foundation is thus more reflective of profitability than anything else, and because of this, we can anticipate certain decisions in the future that flow from this foundation. In a sense, it's how they choose to operate, and it's how they come to the decisions that they do. This idea of a foundation can even be extended the people around us. While we may have a difficult time understanding someone, their foundational perspective of the world around them is ultimately reflected in the daily decisions they make.

Although the idea that foundations affect daily decisions sounds like an obvious way we already think, it's important to note the implications of this in the environment around us. We should always be aware of our purpose and foundational core when making a decision, especially when we (as students) will be placed in an environment where ethics are highly regarded. We don't want to find ourselves straying and stretching from the ultimate goal of financial reporting – to better reflect the true nature of a business.

III. 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.

To continue from the end of the previous answer, this idea of a foundational core is pivotal to the decisions we should make as accountants. When faced with a choice between pleasing your client and following strict guidelines, it may seem like we'd always choose to follow the ethical choice. But in reality, we are humans who seek the affirmation of others. We don't want to make decisions that will ultimately frustrate, disappoint, or annoy someone else, especially when that someone else is paying a large sum of money for the job that you're doing.

However, it is our duty as accountants to follow the principles set up in the current financial standards. This, in the long run, will prevent future failures and faults that have the potential to place people in a disadvantaged circumstance. For example, Enron and WorldCom created much turmoil for a large amount of people. These were the accumulated effects of decisions made from a faulty foundation. If these companies would have taken the time to lay out their foundations, they could have prevented a lot of the problems they faced.

Arthur Anderson is a great example of a large firm whose fall was the effect of the decisions made from a select few. These people did not follow the foundational pillars that the firm represented, and because of that, it forced many people to lose their jobs (and any money that that job brought them). Foundations are important to evaluate, and they are also important to challenge if the foundation isn't clear or reflective of the current circumstance.

Another way this article will be useful for me in my career is that it taught me to develop an opinion. Although most people don't prefer people to have large opinions about many things, I believe it's good to at least have them (you just don't have to always voice them). These authors have proven to me that they have truly contemplated the aspects of the current method for financial reporting, and they taken that thought process so far as to consider an alternative. Many times, we follow the guidelines, without taking the time to truly think about the process that we are following.

This can be dangerous in the workplace. I may run into a situation at work, where my boss wants me to follow specific guidelines that employees must follow. I can follow those guidelines and not think anything more about them. Or, I can follow what my boss says, while understanding that processes can be changed and made better. Instead of blindly following the principles given, I could follow them and think of ways that they could be made even better. These accumulated ideas could then be presented to my authority, who refines and utilizes the changes and possibly free future employees to do other tasks.

Overall, the takeaway I took from the paper was that I should be willing and able to think on my own and develop my own thoughts. It's okay to challenge the standards in an effort to improve what we see around us.

Ridge Brohaugh

Dr. Dickinson

Case 12: Google

3 May 2019

Executive Summary:

In this case we examined the financial statements of Google in order to consider the various perspectives that investors take when valuing a company. To start, we read an article that briefly described the reason, history, and potential of non-GAAP performance measures. This article gave us a better look at why investors use these performance measures, and how companies adjust their earnings to reflect these performance indicators.

By looking at Google press release from January 30, 2014, we were able to evaluate the methods that Google took to reconcile their actual GAAP net income to their non-GAAP net income and operating margin. In order for companies to report non-GAAP measurements the must meet three requirements: it must be accompanied by the comparable GAAP measures, calculations that compute the various adjustments, and descriptions for each of the adjustments. If a company doesn't do this, it fails to follow Item 10(e) of Regulation S-K.

We then looked in to the stock prices of Google over the year of 2013. These stock prices significantly increased throughout the year, up to 60 percent by the end of 2013; however, Google wasn't the only stock to show increases in the year. The NASDAQ index, when compared to that of Google, also showed consistent increases throughout the year, but it did not increase as quickly as that of Google. By comparing the stock prices to earnings, we were able to see just how influential a company's earnings are for investors because the relationship was almost perfectly related.

Overall, the case was an excellent way to understand the importance of earnings for a company. Not only do earnings show potential cash flow in the future, but it also shows that investors are willing and able to invest in companies with high earnings because the probability of return is quite high.

I. 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.

a. 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?

According to GAAP, companies can adjust their net income to a non-GAAP financial measure; however, they must accompany their adjustments with the comparable GAAP measure, a reconciliation between the amounts, and a description of the reason that each particular adjustment is useful for investors. So, when considering Google's financial reconciliation of non-GAAP results, we must first check to make sure that these three conditions are met.

In order to adjust to non-GAAP results, Google begins their reconciliation by stating their actual GAAP income from operations. They then adjust the income from operations by the actual operating margin of the company for those three months, which is total income from operations (for the three months ended December 31, 2013) divided by consolidated revenues (of both Google and Motorola Mobile). Google then took that adjustment and eliminated certain expenses/charges/losses that are assumed to be "non-recurring," "infrequent," or "unusual." This total adjustment is then added to actual net income for that period and the outcome of the measurement gives investors their "Non-GAAP Results" and their "Non-GAAP Operating Margin."

Although Google met the three conditions that needed to exist in order to present non-GAAP measurements, I still don't quite agree with these adjustments. Item 10(e), which is the same regulation that sets up the requirements for non-GAAP measurements, explicitly prohibits adjustments that are "infrequent," "unusual," or "non-recurring" when there has been similar adjustments within the previous two years of the business. In my opinion, from evaluating the different adjustments (stock-based compensation expense, restructuring and related charges, net loss from discontinued operations) appear to be adjustments that Google makes for every period. At the same time, however, just because these charges or expenses have been made in previous years does not mean that an adjustment may not be made. The company still has the capability to adjust what it "believes appropriate, subject to Regulation G and other Item 10(e) requirements.

II. Use the attached stock-market charts for Google for the period January 1, 2013, through February 14, 2014, to answer the following questions.

a. Compare Google's fiscal 2013 earnings performance with the movement in Google's stock price over 2013.

In the information provided in the case, we are given the consolidated statements of income from the years ended 2011, 2012, and 2013. In 2011, Google had a net income of $9,737, and those earnings continued to rise through 2012 ($10,737) and 2013 ($12,920). More specifically, in 2013, each quarter reported higher earnings than the previous quarter, with quarters 3 and 4 showing significant changes in their levels of earnings.

As one would assume, the stock prices of Google changed in accordance with the level of earnings that Google had. The symmetry between the two is almost a perfect relationship, and this shows that investors are almost entirely basing their decisions on

Google's ability to earn money from their operations. In terms of non-GAAP measurements, this means giving investors measurements that they deem valid and useful in determining their investments.

b. 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).

Looking at the NASDAQ Index in relation to that of Google's stock price for 2013, we can first determine that Google had a consistently higher performance than that of the average NASDAQ index. Secondly, we can see that the overall performance of the index increased at quite similar rates. The index fell in certain periods that Google' value decreased, and the index rose in certain periods when Google's price increased. From this, we can assume that Google either has a significant influence on the entire index, or we can assume that the overall economy was improving at similar rates within the market.

c. 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.

Before the end of January 2014, Google stock price had a sizeable and sharp drop. However, a day or two before February (January 30) their was a considerable spike in the stock price. This spike eventually smoothed out in an increasing manner right into February's valuations. This makes me think that Google, perhaps, was losing its value temporarily; however, when the press release came out, the market quickly perceived it as "good news," and its ephemeral slump quickly disappeared.

III. j. Read the *Wall Street Journal* article from January 30, 2014 titled "Google Reports Higher Profit."

a. 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?

Analyst forecasters predicted that Google would have earnings of $12.20 per share, but Google only saw earnings of $12.01 per share. At the same time, however, analysts also predicted that Google would report $16.8 billion in revenue, and Google exceeded that with $16.9 billion in revenue. Although the analysts didn't have their expectations met on Google's earning per share, the market didn't reflect any sort of disappointment with the performance of Google, so , non, the relations are not quite consistent. Google had impressive growth in 2013, and that was reflected well in Google's 60% increase in stock price.

b. 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?

A strong indicator of performance was Google's claim that its clicks on the company search advertisements (on of its sources of income) increased by 31%. Also, Google is focusing in on consumer behavioral changes from desktop computing towards mobile surfing. Google has developed image-based ads that are more useful for phone screens because of their “bite-sized” qualities. Another contribution towards investors’ confidence in Google comes from Google’s decision to sell its ownership of Motorola and “eliminate a potential distraction.”

Although Google has many good indicators for future success, there are a couple factors that may cause concern or Google going forward. The first of these concerns is that Google receives less payment for each click – a drop in 11% for the year. Considering this is a significant determinant of their overall revenue, it’s important that Google finds ways to build their advertisement margins in the future. Secondly, Google is going to have to continue to adjust to the movement towards smartphones, amidst the myriad of competitors already saturated in the market. Facebook, for instance, already does a large amount of advertising through phones, using their smartphone applications. Google will have to find ways to offer advertising to companies that reach customers in a unique and interactive way.

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