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AN ANALYSIS OF CASE STUDIES RELATED TO FINANACIAL ACCOUNTING  
CONCEPTS AND METHODS

By

Alexander Pierce Watkins

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

Oxford, MS

May 2020

Approved by

A handwritten signature in black ink that reads "Victoria Dickinson". The signature is written in a cursive style and is positioned above a horizontal line.

Advisor: Dr. Victoria Dickinson

A handwritten signature in blue ink that reads "W. Mark Wilder". The signature is written in a cursive style and is positioned above a horizontal line.

Reader: Dr. W. Mark Wilder

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## ACKNOWLEDGEMENTS

To my parents especially: thank you for raising me in a way that enhanced my drive for success. Without you two supporting me the whole way, none of this would be possible. Thank you to Henry County High School for instilling in me a desire to go above and beyond the social norm. Thank you to the Patterson School of Accountancy for providing me with unbelievable professors and opportunities at every turn. Lastly, thank you to the Sally McDonnell Barksdale Honors College for giving me a community to confide in, and constantly pressing me towards success.

## ABSTRACT

ALEXANDER PIERCE WATKINS: An Analysis of Case Studies Related to the Field of  
Financial Reporting in Accounting

(Under the Direction of Dr. Victoria Dickenson)

The following thesis provides answers and descriptions to questions posed in various case studies that have to do with financial accounting. The cases generally cover topics such as Generally Accepted Accounting Principles, how specific fictional or real companies have navigated their complexities, the student's takeaway from the material, and a technical real-life application. Taking Intermediate Financial Accounting in conjunction with the completion of these cases allowed us to gain a deeper understanding of the subject material we were learning in and out of the classroom. This thesis helps display that deeper understanding through the preparation of financial statements and the ensuing analysis of them, the study of current topics in accounting, and the ability to think critically about unclear standards and practices. The series of case studies were completed with the direction of Dr. Victoria Dickenson per the requirements of the Sally McDonnell Barksdale Honors College and the Patterson School of Accountancy.

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## **Case One: Data Analytics**

A Study of Using Hadoop in Financial Accounting

Prepared By: Alex Watkins

August 28, 2018

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## **1.1 Case Introduction**

Accounting is a field that is constantly being affected by the new and innovative advances in modern technology. Data analytics tools have opened a whole new door for accountants to utilize. The mass quantity of data that tools such as Hadoop can filter through has enabled accountants to more efficiently and effectively use or analyze the data presented to them in ways they never would have previously imagined. The speed that these technologies maneuver through massive amounts of data cuts the time spent mulling over such figures down significantly. It not only allows them to make more informed decisions, but it also creates a broad scope of opportunities to view the data in new and pioneering ways. This case dives into the capabilities and uses of this valuable technology.

Hadoop was a very new and, at first, daunting technology to me. After delving into the complicated subject that is data analytics tools, I was amazed to find how useful Hadoop could really be, whether it be within the scope of accounting or outside of it. Data analytics is an industry that will be exponentially growing in years to come, as our society moves towards a more streamlined, web-based system. Through my research, I learned a lot about a subject that will directly affect me at some point in my career, and also how a tool such as this one could positively impact a firm's normal operations.

## **1.2 Purpose of the Tool**

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

Hadoop, when broken down to its most vital functions, is essentially just a way of storing enormous sets of data across several servers/computers for later analysis. What makes this program stand out from others like it is: its relative simplicity, its ability to store and use much larger sets of data than your usual single server database could handle, and the ways the program can use/analyze this data. Hadoop has two main parts: a data processing framework and a filesystem for the storage of data. The Hadoop Distributed Filesystem (HDFS) is the part of the system that acts like a box that holds all your unfiltered, unprocessed data until you are ready to do something with it. The part of the tool that actually processes your data is known as MapReduce. Big data is scattered all throughout the business world. Usually, businesses create or encounter more data than they actually realize, or frankly care to deal with. This tool allows businesses to sift through data to identify trends, analyze transactions, and base their future decisions off of. As I mentioned earlier, Hadoop is unique in the fact that it spreads out your data

across multiple machines, dividing the work to multiple computers. This allows businesses to record virtually every piece of data they come across, whether they deem it useful or not, and analyze it at their own convenience. Just having this ability allows analysts to make more informed decisions about data they previously did not have access to.

### **1.3 Business Setting**

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

#### **Auditing**

1. One of the benefits, and in my opinion the largest, is the ability to track every change in any given file. This helps administer control over the access to your data, while at the same time identifying who tampered with/used what data when. This is especially useful for auditing because of the ability to see who accessed, or even *tried* to access files. Say it were an external audit, the auditor would be provided with all the information on who changed what within the data they are auditing, or how many times they entered the wrong password before gaining access. By streamlining this information, you reduce the time for the external audit, saving your company time and money.

2. Another would be searching for inconsistencies within a particular data set. Say you were examining the selling/shipping of ABC Company's teddy bears and wanted to see if how many the company reported selling matches their shipping receipts. Or if you wanted to make sure that the company was being consistent with recognizing revenue within the right period, you could compare the completion of the making of the teddy bears to when they were actually sold.

3. An area in which I believe this technology could also be put to good use is within warranties and returns. In auditing, especially with companies in retail, returns can cause problems with the financial statements. Say a company was trying to boost their figures by not reporting some of their returns and just recognizing the revenue from selling the item. Hadoop allows access to huge sets of raw data, and it can match all the returns to whether or not the company reported the return with ease, saving the auditor a lot of time.

## **Tax**

1. Tax is an area that was a little more complicated to find technical business applications for, but after some digging, I found a few areas in which Hadoop would increase efficiency/effectiveness. One of those could be tax planning across countries. With Hadoop, there is no need to structure or format your data, all you have to do is dump it into the HDFS and then pick what you want to do with it. So, if you were looking for a way to save a company some money on taxes, you could mine the data from several

different countries for a multinational company, and identify areas (using the heatmap function) in which tax rates were lower, and move your operations to that area thereafter.

2. Another use would be analyzing past data, such as expenses and revenues, to identify trends within the data and use it for predicting future ones.

3. Another use I thought of would be to see what functions, especially administrative functions, are used the most or the least. By doing this, you could identify which functions could be streamlined/automated or gotten rid of altogether. This would also be useful to determine what data is important and needs to be flagged, and what data is not used very much.

## **1.5 Message to Partners**

**TO:** Bill Webb

**FROM:** Alex Watkins

**DATE:** 8-28-18

**SUBJECT:** Investment in Hadoop

Hey Bill,

In my professional opinion, I believe Hadoop is a data analytics tool that would be extremely beneficial to our company. In today's world, big data is becoming more and more prevalent in all forms of business, as the world moves towards putting data online. With a tool like Hadoop, we could capture all data that we come across, whether we find it immediately useful or not. This would allow us to be more informed than we ever have been in the past, while simultaneously saving us time and money that would otherwise be devoted to processing all this data ourselves. As far as the benefits of this specific data analytics tool compared to others, for one Hadoop is one of the faster, cheaper technologies currently available and can be easily integrated into our normal operations because of its relatively simple operating system. Instead of one big operating system, Hadoop splits the data into chunks and sends chunks to different computers to independently process. This also prevents losing data due to failures, because if one chunk fails, one on another computer can seamlessly recover the data from the failed chunk.

Using Hadoop impact our business would streamline many processes across tax and auditing. By creating this ease of access to vast amounts of data, as well as how we could analyze that data, the structure and normal operation would change. We certainly would not have to hire as many people to do the grunt work (collecting/classifying/organizing data), as Hadoop would do that for us. Not only that, but the program could identify trends within our data that we may not have been able to see, or even realized before. Our future engagements would then be more informed and calculated. I hope you consider this information and get back to me with your thoughts.

All the best,

Alex Watkins

**Case 2: Rocky Mountain Chocolate Factory, Inc.**

A Preparation/Analysis of Financial Statements

Prepared By: Alex Watkins

September 12, 2018

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## **2.1 Case Introduction**

This particular case dealt with Rocky Mountain Chocolate Factory Inc.'s financials. We were given a list of transactions that occurred in the 2010 fiscal year, and we had to translate them onto their respective spots on the trial balance, while at the same time creating journal entries for the transactions. Following this, we prepared adjusting entries, calculated our pre-closing trial balance, and then our closing trial balance. Once we had our financials figured out, we moved on to creating our different financial statements, based off of the trial balance. This case tested our ability to identify what accounts are affected by any particular transaction, and also our ability to create financial statements. By completing this case, I have enhanced my ability to navigate and operate Microsoft Excel, an application in which before this I have not had much experience dealing with. This will put me at a distinct advantage above others because I will have had direct experience in creating financial statements and trial balances on Excel.

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

Journal Entry #	Account Name	Dr	Cr
1	Inventories	7,500,000	
	Accounts Payable		7,500,000
2	Inventories	6,000,000	
	Accrued Salaries & Wages		6,000,000
3	Cash	17,000,000	
	A/R	5,000,000	
	Sales		22,000,000
	Cost of Sales	14,000,000	
	Inventories		14,000,000
4	A/P	8,200,000	
	Cash		8,200,000
5	Cash	4,100,000	
	A/R		4,100,000
6	Sales & Marketing	1,505,431	
	General & Admin	2,044,569	
	Retail Operating	1,750,000	
	Cash		2,000,000
	Other Accrued Expenses		3,300,000
7	Accrued Salaries & Wages	6,423,789	
	Cash		6,423,789
8	Cash	125,000	
	Deferred Income		125,000
9	Property & Equipment	498,832	
	Cash		498,832
10	Retained Earnings	2,407,167	
	Dividends Payable		3,709
	Cash		2,403,458
12	Cost of Sales	216,836	
	Inventories		216,836
13	Depr & Amort	698,580	
	Property & Equipment		698,580
14	General & Admin	639,200	
	Retail Operating	6,956	
	Accrued Salaries & Wages		645,156

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

<b>ROCKY MOUNTAIN CHOCOLATE FACTORY, INC</b>		
<b>Income Statement</b>		
<b>For The Year Ended February 28</b>		
		<b>2010</b>
<b>Revenues</b>		
	Sales	22,944,017
	Franchise and royalty fees	5,492,531
	Total Revenues	28,436,548
<b>Costs and Expenses</b>		
	Costs of sales, exclusive of depreciation and amortization expense of \$336,009, \$370,485 and \$389,273, respectively	14,910,622
	Franchise costs	1,499,477
	Sales & marketing	1,505,431
	General and administrative	2,422,147
	Retail operating	1,756,956
	Depreciation and amortization	698,580
	Total costs and expenses	-22,793,213
<b>Operating Income</b>		<b>5,643,335</b>
<b>Other Income (Expense)</b>		
	Interest expense	0
	Interest income	27,210
	Other, net	27,210
<b>Income Before Income Taxes</b>		<b>5,670,545</b>
<b>Income Tax Expense</b>		<b>-2,090,468</b>
<b>Net Income</b>		<b>3,580,077</b>
<b>Basic Earnings per Common Share</b>		<b>0.60</b>
<b>Diluted Earnings per Common Share</b>		<b>0.58</b>
<b>Weighted Average Common Shares Outstanding</b>		<b>6,012,717</b>
<b>Dilutive Effect of Employee Stock Options</b>		<b>197,521</b>
<b>Weighted Average Common Shares Outstanding, Assuming Dilution</b>		<b>6,210,238</b>

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

Rocky Mountain Chocolate Factory, Inc.				
Balance Sheets				
AS OF FEBRUARY 28				
				2010
<b>Assets</b>				
<b>Current Assets</b>				
Cash and cash equivalents				3,743,092
Accounts receivable, less allowance for doubtful accounts of \$395,291 and \$332,719, respectively				4,427,526
Notes receivable, current				91,059
Inventories, less reserve for slow moving inventory of \$263,872 and \$251,922, respectively				3,281,447
Deferred income taxes				461,249
Other				220,163
<b>Total current assets</b>				<b>12,224,536</b>
<b>Property and Equipment, Net</b>				<b>5,186,709</b>
<b>Other Assets</b>				
Notes receivable, less current portion				263,650
Goodwill, net				1,046,944
Intangible assets, net				110,025
Other				88,050
<b>Total other assets</b>				<b>1,508,669</b>
<b>Total assets</b>				<b>18,919,914</b>
<b>Liabilities and Stockholders' Equity</b>				
<b>Current Liabilities</b>				
Accounts payable				877,832
Accrued salaries and wages				646,156
Other accrued expenses				946,528
Dividend payable				602,694
Deferred income				220,938
<b>Total current liabilities</b>				<b>3,294,148</b>
<b>Deferred Income Taxes</b>				<b>894,429</b>
<b>Commitments and Contingencies</b>				
<b>Stockholders' Equity</b>				
Preferred stock, \$.10 par value; 250,000 authorized; 0 shares issued and outstanding				
Series A Junior Participating Preferred Stock, authorized 50,000 shares				-
Undesignated series, authorized 200,000 shares				-
Common stock, \$.03 par value; 100,000,000 shares authorized; 6,026,938 and 5,989,858 shares issued and				180,808
Additional paid-in capital				7,626,602
Retained earnings				6,923,927
<b>Total stockholders' equity</b>				<b>14,731,337</b>
<b>Total liabilities and stockholders' equity</b>				<b>18,919,914</b>

Figure 2-4: Rocky Mountain Chocolate Factory, Cash Flow

Rocky Mountain Chocolate Factory Cash Flows	
	Section of the Statement of Cash Flows
1. Purchase Inventory	Operating
2. Incur Factory Wages	Operating
3. Sell inventory for cash and on account	Operating
4. Pay for inventory	Operating
5. Collect receivables	Operating
6. Incur SG&A (cash and payable)	Operating
7. Pay Wages	Operating
8. Receive franchise fee	Operating
9. Purchase PPE	Investing
10. Dividends declared and paid	Financing
11. All other transacations	-
12. Adjust for inventory count	Operating
13. Record depreciation	Operating
14. Wage accrual	Operating
15. Consultant's report	-
16. Closing entry	-

## **Case Three: Debate**

A Series of Debates About Our Career Paths

Prepared By: Alex Watkins

September 17, 2018

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### **3.1 Case Introduction**

This week's case was certainly one that I found to be a unique experience and learning opportunity. In lieu of a traditional case study, we instead sparked up a series of debates based off of sample pieces of conversations that we happened to "overhear". The topics of the debates spanned across several different areas/focuses of our major, but all had the overlying theme of looking towards the future, and what it might hold for any one of us in the class. I felt as if I benefited a lot from simply talking about some of these topics and scenarios, because as mentioned in class, not every person in the accounting field will really ever have the opportunity to be involved in talking about some of the topics we presented this early on in their career. Much less have as helpful and valuable insight provided to us as we navigated these topics. I learned a lot about the wide span of different opportunities that are available to me as an accounting major at the University of Mississippi, the seventh ranked accounting school in the nation. I also learned a little more about myself, as the debates forced me to formulate my own opinion on some of these topics and dig deeper into my interests/focuses going forward.

### **3.2 Debate One**

This debate was sparked from a conversation between two students talking about wanting to use their accounting degree to go to law school or to go straight into accounting. Before this topic was brought up, the thought of using my degree to pursue a career in law had never occurred to me. Some of the better points for the side of law

school included how you would be receiving a larger salary in your entry position, how it was a more “lasting” job, and there is a better chance for advancement within the field. I found that all of these points were fairly tantalizing to me, although I really have no interest in law or that field in general. It was argued that “money isn’t everything” and you should at least kind of enjoy what you do. Also, even though there is a better opportunity for advancement in a lasting position (people who go into law generally stay there), the point that their starting salary is more is offset by the costs of law school, as well as the fact that by the time a person would get out of law school and into the work force, a public accountant’s salary would most likely have balanced out the difference. I personally took the side of Delaine, who was arguing that law school is kind of a roundabout way of doing it. I sympathized with those who said they did not have any interest being a lawyer, although the work may be somewhat similar in tax law. There is a high job security coming out of Ole Miss, and it is already a very streamlined process.

### **3.3 Debate Two**

The second debate centered around using your accounting degree to become a public accountant, or to use that skill set elsewhere in the business field. Great points were thrown around the room, but those that stuck out most to me are as follows: accounting is the framework for most things in the business field, there is a broad variety of subject within the accounting field for advancement, and our talk around taking internship spots away from those who want to go into public accounting and stay there. I

fall into the category of people who do not see themselves doing public accounting for the rest of their career. All my life I have enjoyed the business world, and I dream of one day owning my own business. With the insight I could gain by serving as a public accountant for several years, I would have the knowledge and know-how to successfully run and manage my business. Granted, I certainly want to land a job and stay there for an extended amount of time, as we learned that these spots for internships are in fact limited, and I'd like to build a good rapport for the start of my career. Corporate America, while not always true, is heavily reliant on who you know. By working my way up through an accounting firm, I could gain lasting contacts that could put me at a distinct advantage in the future. However, I now realize, after deliberation, that the firms want people who are going to stay at their firm, not just use it as a stepping stone. I hope to give a lot back to my firm before I hopefully transfer out one day.

### **3.4 Debate Three**

Our final debate circled the topic that was getting an internship, and then wanting to transfer after completing your time at a specific location. My initial opinions were strongly in favor of the side of transferring locations, but after further discussion I changed my mind. My preliminary thoughts of wanting to change locations originated from me wanting to see and travel to more/new places. Why should I stay in the same city my whole life? What if I did not like how they conducted their business, or their corporate culture? While I do still stick to those beliefs, I think choosing a location to

have your internship is a very deliberate action. Where you want to spend the start of your career should be very, *very* well thought out, as it can positively or negatively affect your future. Before just picking a city or firm, one needs to do extensive research about the place, firm, and determine other factors that might impact you in the long term. These accounting firms are spending a lot of money on us throughout our recruitment, so it almost disrespectful to not pay it forward once you get there. By staying where your original internship was located, you give yourself better chances of building those lasting connections, as well as a better chance at advancing upwards through the firm. Granted, life does happen, and extenuating circumstances could influence you to change locations, I am not ruling that out. But where you work is a huge decision and should not be taken lightly.

### **3.5 Conclusion**

Throughout this case, I learned a lot about the process that we will soon have to go through in order to join the work force. All of the debates were extremely thought provoking, and I definitely think that I learned a thing or two about myself, as well as the major that I chose.

## **Case Four: Generic Bank**

A Study of Debt Security Impairments

Prepared By: Alex Watkins

October 2, 2018

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## **4.1 Case Introduction**

This case examined the accounting for and around debt security impairments in banks, putting emphasis on determining whether or not said debt securities were impaired. We examined a situation where Generic Bank wanted to free up some liquidity by selling seven different debt securities. We analyzed whether or not the securities should be classified as impaired or not from the perspective of the bank, as well as an external auditor and bank regulator. This allowed us to identify different factors that might influence our decisions depending on what point of view we looked at it from. These different perspectives each had their own viewpoint, which could be useful for giving a unique point of view on each perspective.

By completing this case, I learned several things. For one, I got to do some in-depth reading of Accounting Standards Updates which broadened my knowledge on debt securities and impairments. Further, this allowed me to get a sneak peek at how accountants would use ASC as guidance in their work, as well as serving as a tutorial in how to research and find such guidelines. Ultimately, I believe this case required me to think critically, and formulate my own opinion on a gray area of the codification which in turn taught me a lot about an aspect of accounting that I had not previously encountered.

## **4.2 Questions Answered**

1. Generic Bank is selling seven securities in order to generate cash. There is an impairment loss on five of the seven securities, which include securities 003, 015, 025, 030 and 076. Because there is a gain on account numbers 067 and 096, you would not count those as an impairment loss. This is due to ASC 326-30-35-4, which states that impairment shall be assessed at the individual security level. Also, ASC 326-30-35-1 states that an investment is impaired if the fair value of the investment is less than its amortized cost basis, which constitutes the impairment of the aforementioned securities, excluding 067 and 096.

2. In my opinion, I do not think you would recognize an impairment loss on the securities, excluding the five mentioned above. The bank made a reasonable assumption in saying that none of the losses from debt securities came from credit losses, but instead coming from changes in interest rates. Also, Generic Bank claims that it has the intent and ability to hold these securities until they mature, or the unrealized losses recover. According to ASC 326-30, the bank is the one responsible for determining whether or not an unrealized holding loss on available-for-sale debt securities should be classified as impaired or not, and as I mentioned above, they determined that the loss was from a change in interest rates, and also claimed that they have the ability and intent to recover from these losses or wait until the securities mature, making it so you would not recognize these as impairment losses.

3. If I assumed the role of an external auditor, I would first determine whether or not a credit loss exists in the for-sale securities according to ASC 326-30-55-1 through 326-30-55-4. Since it all checks out, and we assume the banks position on the matter to be reasonable, I would agree with their verdict to not recognize the remaining securities not-for-sale as impairment losses. I think because you are not selling them, I don't think the auditor would deem it necessary, nor cost effective to examine each of the securities individually to determine whether or not there was credit loss. From the role of the bank regulator, I agree with the judgement of the external auditor. Other factors that I might consider when looking at these securities are what the securities decline in value was caused by. Common reasons I would look for would be physical damages, permanent reductions in market value, or legal issues against the security.

4. If the securities sold had been collectively in a net gain position, the only thing that would change is you would not recognize those with individual gains as an impairment loss. If all the securities were in a gain position, then there would be no impairment loss at all according to ASC 326-30-35-1, which states that an investment is impaired if the fair value of the investment is less than its amortized cost basis. If they were all in the gain position, then none of their fair values would be lower than their amortized costs, thus no impairment has occurred.

5. Generic Bank now desires to sell securities to improve capital ratios and free up some liquidity. This is a similar situation to the one we encountered in question two, the difference being the bank is adequately capitalized instead of well capitalized. I believe that in this instance the accounts are impaired, as the lowered capitalization status of the bank may lead to an inability to hold these securities that are in the loss position until they either mature or losses recover. According to ASC 326-30-35-2, you would record these losses in other comprehensive income, net of tax. You would report it there because we determined that the impairment is not due to a credit loss.

## **Case Five: City Selection**

Research About Potential Geographic Work Locations

Prepared By: Alex Watkins

November 1, 2018

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## **5.1 Case Introduction**

This case tasked us with choosing two cities in which we might work sometime in the near future and answering a series of questions regarding how our life would be if we were to choose the respective city. Through completing this case, I learned a lot about Nashville, TN and New York, NY, my two top prospects at this time. I learned that the rents in the downtown areas of both of these cities are not cheap at all and would take the majority of my paycheck starting out. Also, I got a real reality check through seeing what costs I would incur in the respective cities, and I got a better glimpse as to what my life might look like in the near future.

## **5.2 NASHVILLE, TN**

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

The 13-county metropolitan area is estimated to have 1.75 million people, and the consolidated population is estimated at 626,600

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

Like most other southeastern states, the climate of Nashville falls under the humid subtropical classification. Winters are short and mild, summers are long and hot, and humidity and precipitation tend to be on the high side.

### **3. Describe the city's topography, scenery, and other geographic or geological features of the area in which the city is located**

Nashville is located on the Cumberland Plateau, so the elevation ranges from 385 feet above sea level to 1,163 feet above sea level at the beautiful Radnor Lake State Natural Area. Downtown Nashville holds beautiful buildings, such as the AT&T "Batman Building", the Capital Building, The Country Music Hall of Fame, and even a full-scale replica of the Parthenon held within Centennial Park.

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

The sales tax rate in Nashville is 9.25 percent, 7 percent being the state's rate and 2.25 percent being Davidson County's rate. Food items are taxed at 5 percent. There is no income tax from salaries, wages, bonuses, or any other type of income-for-work, but there is a 6 percent interest rate on income from stocks, bonds, and notes receivable. Using a take home paycheck calculator, my semi-monthly take home pay would be \$1,609 semi-monthly.

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

Nashville is one of only six cities in the nation where three interstates connect. These include I-65, I-40, and I-24. More than 28,000 parking spaces make it easy to park a car downtown. There is a bus system that goes around the city as well as taxis. A commuter rail has six stations between Lebanon and the destination station at Riverfront Park in downtown Nashville. Nashville also features an International Airport.

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

The healthcare industry is the top industry, and Nashville is often referred to as the nation's health care center. Twenty-one health care companies are based within the city, and 350 health care companies have operations there. Almost 90,000 people in

Nashville metro area worked in the health care industry, earning more than a \$4 billion payroll.

Music is what makes Nashville most famous. Known as the Country Music Capital of the World, the music industry has pumped billions of dollars into the local economy, creating a thriving entertainment business scene ranked behind only New York and Los Angeles.

The third largest is probably the Tourism and Hospitality industry, and fourth is Automotive Manufacturing.

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

Nashville has one of the leading healthcare industries in America, so naturally the quality of healthcare in the city is very good. With world-renowned hospitals such as Vanderbilt and Baptist Hospital, as well as nearly thirty others, one has a wide variety of high-quality medical services at their disposal.

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

There was a total of 32,090 reported incidents in 2016, with 7,371 of those being violent crimes (murder, rape, robbery, assault), and 24,719 of them being property crime (burglary, theft, vehicle theft). You have a one in ninety-one chance of becoming a victim of violent crime and a one in twenty-one chance of being a victim to any crime at all.

Downtown Nashville is prone to crime, as are many downtown areas. It is recommended to avoid East Nashville, as it is one of the more dangerous places in the city. Lastly, another high crime area is the Antioch area.

**9. Based on where you see yourself living for the first three years, how much rent do you expect to pay? Back up this assertion with sample properties from each location. Describe the square footage, amenities, need for a roommate, availability of parking, etc.**

This is a somewhat complicated question for me, as my mom's side of the family lives in Nashville and my first cousin is a relator in the area. If I wanted to live near my family, I would try to find a location in Brentwood, a suburb of Nashville, with the help of my cousin. More than likely, however, I would want to live downtown to start off, so I am looking at around a \$1,200-1800 monthly rent. After some research, I identified the Gulch as an area that I would like to get an apartment in. I found a 1 bathroom, 442 square foot, studio apartment with a rent of \$1,289 a month at a place called "Velocity in the Gulch". It features a washer/dryer, internet, A/C, cable, dishwasher, and a few other basic amenities. You get one space in the parking garage for a \$75-dollar fee.

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

The typical mode of commuting in Nashville is by car, but if I were to live in the Gulch, it would be entirely possible for me to walk to my job site. If I went by car it would be no more than a ten to twenty-minute drive and about the same for walking.

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

As I am a loyal Kroger shopper, I would most likely drive to Kroger to do my grocery shopping. There is a Kroger very close to downtown Nashville.

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

My apartment in the Gulch would feature a washer/dryer, so I would do it there.

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

One organization I would like to be active in is the Episcopal Church located in downtown Nashville. A second one to get involved with would be Hands On Nashville, which is a charitable organization that offers hundreds of volunteer opportunities. Lastly, I someday desire to own my own business, so the Nashville Entrepreneur Center would be a good way to vocalize my ideas and learn more about entrepreneurship while networking.

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

Nashville is a hub for entertainment, so there is no lack of recreational activities to participate in. First and foremost, my family is season holders of the Tennessee Titans tickets, so I would be sure to go to as many games as possible. Second, I am a big Nashville Predators fan, so I would go see hockey games in Bridgestone Arena. Also, in Bridgestone Arena there are constantly concerts so that is another option for me. Broadway holds countless bars and restaurants, so I would most certainly have to frequent Broadway. Lastly, the Country Music Hall of Fame is there along with many other tourist attractions if I wanted to do those.

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

If I wanted to travel home, it is a short two-hour drive on I-40 back to Paris, TN. The average cost would only be a half tank of gas, so about 30-40 dollars depending on gas prices.

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

Category	Amount
Rent	1,300
Utilities	130
Cell Phone	110
Food/Groceries	350
Health Care	103
Personal Care	100
Entertainment/Fun	300
Savings	1200
Car Payment	300
Total	3,893

*Figure 5-1: Monthly Operating Budget, Nashville*

## **5.3 NEW YORK CITY, NY**

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

The population of New York City is over 8.6 million people. A city of this size is something I have never experienced before, coming from small town Tennessee. I think this would be something I would enjoy experiencing, as it would truly broaden my horizons.

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

New York City has a humid subtropical climate, with cold winters and hot, moist summers. Since the city has a coastal location, it is not as cold as inland cities on the same latitude. Snow is common in the winter, but the amount varies, and winter rain is common. Spring is pleasantly warm, and summers are hot and humid.

### **3. Describe the city's topography, scenery, and other geographic or geological features of the area in which the city is located**

The topography is a very urban environment, and the Hudson and East rivers run through it. Many iconic landmarks are held within New York, such as The Statue of Liberty, the Empire State Building, and the iconic Times Square.

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

Using a take home paycheck calculator, I calculated (with a \$50,000/year salary) a take home pay of \$1,547 semi-monthly. This was using an 18.07 percent tax rate, and a 7.65 percent reduction for FICA.

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

One of New York's most prevalent modes of transportation is its extensive subway system, and it is certainly the most used one. There are four major airports in the area, including JFK International Airport, culminating to what is one of the largest systems in the world. Bus systems exist as well as numerous taxis.

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

The most prevalent industries in order of size are as follows: financial services, health care, professional and technical services, retail trade, and lastly manufacturing and educational services.

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

Being of the largest cities in the world, NYC requires an extensive amount of hospitals and clinics throughout the five boroughs of the city. There are 62 acute care hospitals in NYC, offering a wide range of care available if I were to ever need it.

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

According to a 2015 ranking of 50 cities by *The Economist*, New York was the 10<sup>th</sup>-overall-safest major city in the world, as well as 28<sup>th</sup>-safest in personal safety. This is due to a drop in violent crime from NYPD officials patrolling the streets and enforcing harsh penalties on violent crime offenders in the area. The most common crime in New York is drug possession. The neighborhoods with the highest rates of violent crime are: Vinegar Hill (Brooklyn), Downtown Brooklyn, Theatre District/Times Square, Meatpacking District, and a few others.

**9. Based on where you see yourself living for the first three years, how much rent do you expect to pay? Back up this assertion with sample properties from each location. Describe the square footage, amenities, need for a roommate, availability of parking, etc.**

Obviously, the rent anywhere in downtown New York is going to be very expensive no matter where I choose to stay, so I limited the area of where I would pick an apartment to places that would be within walking distance of the Big 4 firms in Manhattan. I found a 1 bed 1 bath apartment in Hell's Kitchen for \$3,000 dollars a month. I would most certainly have to split this with at least one roommate, if not two. This would cut the cost down significantly. The apartment features basic amenities, along with a fitness center, laundry facilities, and a landscaped garden.

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

My plan would be to live in Manhattan, so driving a car is certainly not an option. I would either take the subway or simply walk to work. If I rode the subway, I would just buy the annual pass for \$121. A taxi or Uber/Lyft would also be another option for me if I needed to travel by car. If I lived elsewhere, the subway is a great form of transportation.

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

I don't really know how grocery shopping goes in New York, but I learned that it is very different than simply driving to your local Walmart. Grocery shopping and home cooking would save me a lot of money in the long run, but I definitely want to try out the huge variety of dining options that NYC has to offer. If I were to buy groceries, I would frequent the different stores near my apartment.

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

The apartment I picked out has laundry facilities located within it, so I will do my laundry there.

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

A civic organization I would like to be a part of is New York Cares, which offers year-round opportunities and makes volunteering simple by partnering with more than 1,300 nonprofits and schools in the city and leading 1,600 volunteer projects every month. A religious organization I would like to be a part of is any Episcopal Church that I could find and fit in well with. Lastly, another good charitable organization to get involved with would be the Coalition for the Homeless.

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

There really is no limit to what you can do in NYC, limiting the scope to five activities really doesn't do the city justice. As I mentioned earlier, there are over 45,000 restaurants in NYC, so you could essentially eat forever. I have a big appreciation for the arts, so a Broadway musical is something I would very much enjoy attending. When it comes to sports, there are two MLB teams, three NHL teams, and two NFL teams. All of these, plus a thousand more things that I have not even discovered yet, would provide me with plenty of options to make the most of my time in the city that never sleeps.

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

Driving back to Tennessee would be a little difficult, so flying would be most likely my only option. The cost of a plane ticket from Newark to Nashville ranges from \$150-\$300, depending on the airline company and time of the year. From there, my family would pick me up from Nashville.

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

Category	Amount
Rent	1,600
Utilities	175
Cell Phone	110
Food/Groceries	490
Health Care	125
Personal Care	150
Entertainment	200
Fun	150
Savings	1000
Total	4000

Figure 5-2: *Monthly Operating Budget, New York City*

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

After completing all this research, I definitely think I would still want to live in either of these cities. I think both would be a great experience, but overall Nashville is still my preferred city. I am heavily considering New York, but it might be a little out of my comfort zone, as I have never experienced anything like that before. In Nashville, I would certainly have more connections through my family and the people they are already connected with, as well as people that I know that live in Nashville. This would give me a distinct advantage starting my career there. I believe that for the betterment of my future, Nashville would be the smartest, and more preferred move for me.

## **Case Six: WorldCom**

Capitalized Costs and Earnings Quality

Prepared By: Alex Watkins

November 1, 2018

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## **6.1 Executive Summary**

This case dealt with WorldCom, a telephone company that improperly capitalized mysterious “line costs”, leading to the falsification of financial statements. The upper management of the company worked in cahoots to cover up the fraud and to put WorldCom in a significantly better position in the eyes of their stakeholders. The aggressive acquisition strategies taken by the CEO eventually caught up to him, and instead of losing the stakeholder’s confidence, he conspired to commit large-scale fraud. The eventual demise of WorldCom proved tragic for many people when the fraud was uncovered, and many people lost their jobs and even more lost a lot of money. The following questions deal with the details and some background information behind WorldCom.

## **6.2 Questions Answered**

**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.**

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

FASB defines an asset as probable future economic benefits obtained or controlled by a particular entity as the result of past transactions or events. It also defines expenses as outflows or “other using up of assets,” an incurrence of liabilities, or a combination of both descriptions.

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

In general, costs should be capitalized when one of three conditions are met: the useful life of the asset is increased, the quantity of service produced from the asset is increased, or the quality of the units produced are enhanced. For a cost to be expensed, all the cost has to do is cause the asset to maintain a given level of service.

**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.**

After capitalization, costs become depreciable, and are expensed over time. On the Income Statement, net income is lower because instead of counting your cost as an expense, you are capitalizing it and classifying it as an asset that only creates an expense from “depreciation”. On the balance sheet, the capitalized costs show up as Property, Plant and Equipment, so assets would be overstated.







Quarter	Capitalized Amount	Depreciable Base	Portion of Year	Depreciation Expense
Q1	771,000,000	35,045,454	1	35,045,454
Q2	610,000,000	27,727,273	$\frac{3}{4}$	20,795,455
Q3	743,000,000	33,772,727	$\frac{1}{2}$	16,886,364
Q4	931,000,000	42,318,182	$\frac{1}{4}$	10,579,545
<b>Total</b>				<b>83,306,818</b>

Figure 6-1: Quarterly Depreciation Calculation

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

Income Before Taxes, as reported	2,393,000,000
+ Accumulated Depreciation	83,306,818
- Capitalized Line Costs	<u>(3,055,000,000)</u>
Loss before taxes	(578,693,182)
Income Tax Benefit	202,542,614
Minority Interest	<u>35,000,000</u>
Net Loss, restated	<u>(341,150,658)</u>

The difference in net income is material as what they should have recorded was a net loss of \$341,150,658 instead of net income of \$1,501,000,000.

## **Case Seven: Starbucks Corporation**

A Case Study About Understanding Financial Statements

Prepared By: Alex Watkins

March 4, 2019

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7.2	Questions Answered.....	60

## **7.1 Case Introduction**

This case tasked us with viewing and analyzing the financial statements of Starbucks Corporation, and multinational business with a primary focus on the sale of coffee and related products through the retail market. Through this case, I became much more familiar with navigating through five different types of financial statements in order to pick out needed information. I also got hands on practice in analyzing certain specific lines of the financial statements in order to come to conclusions about different financial indicators of Starbucks itself. This will be useful to me in the future because I will have a familiarity with performing such tasks that might be asked of me as in intern, putting me ahead of the curve.

## **7.2 Questions Answered**

### **A.**

Starbucks is in the business of brewing, marketing, and selling their specialty coffee to a target market. This target market being people interested in buying that name brand, tried and true coffee, with their recognizable logo. Starbucks really enhances this mission to create a brand for itself through the creation of a unique and welcoming atmosphere inside restaurants, as well as offering a wide variety of drinks and foods. Starbucks also creates revenue through selling its products to grocery stores, convenience stores, and other miscellaneous vendors.

### **B.**

Starbucks prepared four different financial statements for external reporting purposes, as follows: income statement, balance sheet, statement of cash flows, and statement of stockholders' equity. They inserted the word "Consolidated" in front of all of the financial statements, meaning the combined financial statements of Starbucks and all of its subsidiaries.

### **C.**

Publicly traded corporations are required to prepare financial statements for external users every quarter, or four times a year. Failure to do this could result in penalties or suspension of the reporting entity.

**D.**

The management of the reporting entity is responsible for the just preparation of financial statements that are in compliance with GAAP. A few examples of people who would use the financial statements are as follows: stakeholders of Starbucks corporations, management within the company, and competing organizations. Stakeholders would be interested in the profits or losses of the corporation in order to value potential stock held for investment purposes in case they wanted to buy/sell it. Management would be interested to compare themselves to similar businesses within the industry, or simply for internal purposes. Competitors would use the statements to identify areas that could use improvement, or for opportunities to capture more of the market.

**E.**

The external auditors of Starbucks Corporation are the Seattle Washington Branch of Deloitte LLP. The first opinion letter states that they have performed the audit according to the standards of the PCAOB. Also, that the consolidated statements provided are an accurate attestation of the financial position of Starbucks Corporation at the given date. The second opinion states that, in accordance with standards set by the PCAOB, Starbucks Corporation has maintained effective internal controls over their financial reporting in Deloitte's "unqualified opinion".

**F.**

Figure 7-1: Starbucks Consolidated Statements of Earnings

<b>Consolidated Statements of Earnings (USD \$)</b>	<b><u>12 Months Ended</u></b>	
<b><u>In Millions, except Per Share data, unless otherwise</u></b>	<b><u>Sep. 29, 2013</u></b>	<b><u>Sep. 30, 2012</u></b>
<b>Net revenues:</b>		
Company-operated stores	79.19%	79.21%
Licensed stores	9.14%	9.10%
CPG, foodservice and other	11.67%	11.69%
Total net revenues	100.00%	100.00%
Cost of sales including occupancy costs	42.86%	43.71%
Store operating expenses	28.78%	29.46%
Other operating expenses	3.07%	3.23%
Depreciation and amortization expenses	4.17%	4.14%
General and administrative expenses	6.30%	6.02%
Litigation charge	18.70%	0.00%
Total operating expenses	103.87%	86.57%
Gain on sale of properties	0.00%	0.00%
Income from equity investees	1.69%	1.58%
Operating income	-2.19%	15.02%
Interest income and other, net	0.83%	0.71%
Interest expense	-0.19%	-0.25%
Earnings before income taxes	-1.54%	15.48%
Income taxes	-1.60%	5.07%
Net earnings including noncontrolling interests	0.06%	10.41%
Net earnings attributable to noncontrolling interest	0.00%	0.01%
Net earnings attributable to Starbucks	\$8.30	\$1,383.80

Figure 7-2: Starbucks Consolidated Balance Sheets

<b>Consolidated Balance Sheets (USD \$)</b> <b><u>In Millions, unless otherwise specified</u></b>	<b>Sep. 29, 2013</b>	<b>Sep. 30, 2012</b>
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%
<b>TOTAL ASSETS</b>	<b>100.00%</b>	<b>100.00%</b>
<b>Current liabilities:</b>		
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%

Figure 7-2: Starbucks Consolidated Balance Sheets

<b>Consolidated Balance Sheet</b> <b><u>In Millions, unless otherwise specified</u></b>	<b>Sep. 29,</b> <b>2013</b>	<b>Sep. 30,</b> <b>2012</b>
<b>Shareholders' equity:</b>		
Common stock (\$0.001 par value) - authorized, 1,200.0 shares; issued and outstanding, 753.2 and 749.3 shares (includes 3.4 common stock units), respectively	0.01%	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%
<b>TOTAL LIABILITIES AND EQUITY</b>	<b>100.00%</b>	<b>100.00%</b>

**G.**

i) Based on Starbucks Corporations Consolidated Balance Sheets, the sum of total liabilities and equity for 2013 equals \$11,516.7 million. This number is equal to the sum of all the assets, also \$11,516.7.

ii) Starbucks' major assets include (from largest to smallest): PPE, cash and cash equivalents, and inventories. This makes sense because as a primarily retail focused firm, you would want to have your property, as well as the equipment used to make the coffee itself, as the biggest percentage of your assets. Naturally your cash and cash equivalents would follow, and then inventories should be a bigger percentage, but you want to keep that number as low as you can and have a high inventory turnover. The proportion of short-term to long-term assets for 2013 is 47.51 percent short-term and 52.49 percent long-term.

iii) Intangible assets are those that lack physical substance. They include copyrights, patents, franchises, goodwill, and a few others. Goodwill comes into play when one company acquires another, and the value comes from the purchase costs minus the fair market value of tangible/intangible assets as well as liabilities. Starbucks most likely has trademarks and copyrights, which classify as intangible assets, on the names of their assorted drinks, and their brand name itself. Another intangible asset might be a patent they have on a specific coffee machine.

iv) Starbucks is primarily financed through its operating income from their company-operated stores, licensed stores, and CPG, foodservice and other, which make up over 80 percent. Alternate sources of financing include 11.28 percent of long-term debt.

## **H.**

i) Revenue is recognized in company-operated stores when payment is tendered at the point of sales. Revenues from the stored value cards are recognized when redeemed or when the likelihood of redemption is deemed to be remote. One challenge that made itself clear was that the gift cards never expire. This creates a trouble area in estimating the likelihood that a customer will redeem the gift card.

ii) Starbucks' major expenses include the cost of sales (including occupancy costs), and their operating expenses essentially makes up the rest. The unique expense for 2013 was the litigation charge.

iii) There were a several changes to the cost structure during the most recent year, the most noteworthy being the litigation charges of over \$2 billion dollars. This accounted for the majority of increase in expenses, but also included in the total increase was an increase in general and administrative expenses, depreciation/amortization expenses, and other operating expenses.

iv) GAAP requires that if a loss qualifies as a contingent liability, and that contingent liability is deemed probable, you must report it within your financial statements. The amount reported must be “fair and reasonable” and a disclosure of important details must be included in a footnote. It is classified as an operating expense because it does not fit under any other category, and because it is a significant and material amount. The litigation faced that brought about this contingent liability was a lawsuit imposed by the workers of the company.

v) Starbucks was profitable during 2013 and 2012. My definition of profitable is in reference to the net earnings attributable to Starbucks, as well as the net revenue numbers from the balance sheet. Although the net earnings number in 2013 was significantly less than 2012, it was still a positive number, and there was even an increase in net revenues. The steep decline in net earnings was most likely attributable to the litigation expense incurred in 2013.

**I.**

i) The net cash provided by operating activities had a sharp increase from 2012 to 2013. This is primarily attributable to the increase in cash provided by accounts payable, accrued liabilities/insurance revenues, deferred revenues, and prepaid expenses. The litigation expenses allowed for an offsetting of certain income. In comparison, net earnings from 2012 to 2013 had a sharp decrease, because the litigation expenses were directly deducted from Starbucks' earnings. Another factor in the cash to earnings difference would be the depreciation and amortization expense.

ii) In fiscal year 2013, Starbucks spent approximately \$1,151.2 million on additions to property, plant, and equipment. Starbucks also gained \$15.3 million from the sale of some of their PPE.

iii) Starbucks, according to their Consolidated Statement of Cash Flows, paid \$628.9 million in cash dividends. Although they paid this number, on the Consolidated Statement of Equity \$668.6 million dollars of cash dividends were declared. The difference, \$39.7 million, represent the dollar amount of cash dividends that are payable for Starbucks Corporation.

**J.**

For any given business, there are certain expenses or figures that are unquantifiable, and require the use of estimates. GAAP requires that these estimates be accurate and relevant to the object they represent, which requires management to make a judgement call in good faith. For Starbucks, the depreciation of assets, impairment of assets, value of intangible assets, dollar amount of receivables deemed to be uncollectable as bad debt, and the percentage of value stored gift card to be redeemed are all examples of items that must be estimated on the Balance Sheet.

## **Case Eight: BP P.L.C.**

A Case Study About Contingencies

Prepared By: Alex Watkins

April 1, 2019

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## **8.1 Case Introduction**

This case is one that revolves around the Deepwater Horizon Oil Spill that happened in 2010. BP was leasing an oil rig in the Gulf of Mexico when on April 20<sup>th</sup>, an explosion and fire led to the death of eleven people and injury of many more. Since then, thousands of claims for damages have been made, and hundreds of lawsuits have taken place. BP immediately was faced with the issue of estimating the contingent liabilities that were certain to arise in the following years.

Through the completion of this case I was able to refine my knowledge of contingent liabilities and how to report those on the books of companies. Also, through examining the situation through the eyes of an auditor, I was truly able to see the multitude of angles people might have grounds to sue BP on. Not only this but going through the process of estimating who would have grounds versus those who wouldn't allowed me to use my own judgement and independent research to come to a decision.

## **8.2 Questions Answered**

### **A.**

The definition of a contingent liability, in my own words, is a liability that may or may not occur, depending on some event that is both uncertain and in the future. A company should report a contingent liability, such as a pending lawsuit, product warranty, or some penalty for a past action, when the event is probable (i.e. your legal department thinks that the opposing firm has a strong case) and also easy to estimate (legal determines a \$4 million-dollar loss if the firm loses the case). It depends on how likely the liability is in order to determine where to report it on the financial statements. A contingent asset is required, by GAAP, to be disclosed in the footnotes of the financial statements.

### **B.**

From the perspective of BP, this product warranty on the telescopic joint is an assurance type warranty. Basically, it is an assurance from GE Oil and Gas that if something were to go wrong with the equipment that they would reimburse them for such damages. So essentially this warranty represents a contingent asset, which would be disclosed in the footnotes of the financial statements.

From the perspective of GE Oil and Gas, this product warranty embodies a contingent liability. This is due to the fact that if BP exercised the redemption of the warranty, GE would be liable to pay them the agreed upon amount. This contingent

liability would either be disclosed in the footnotes or in the balance sheet if it were highly likely that they were to redeem the warranty.

### C.

There are several judgements involved with accounting for contingent liabilities. In accordance with GAAPs Full Disclosure Principle, companies owe it to users of their financial statements to disclose any amount that could affect the company's financial performance. A contingent liability threatens to lower a company's assets and overall profit, negatively affecting the company overall. Not only that, but following the Materiality Principle, all important financial info needs to be disclosed in the financial statements. To be considered material, all the piece of information must do is impact the economic decision making of the users of financial statements. A massive lawsuit against a company could certainly turn investors away from investing in a company, therefore qualifying contingent liabilities as material.

Judgements for a product warranty are slightly less complex, as it usually only entails a customer either returning the product for some fault in the product or the customer redeeming the warranty because they broke it. This case deals with an issue that impacted tens of thousands of people and entities, so the differences are quite stark. There are so many different ways that the company could be liable, such as damages to property, loss of business, less tourism to certain areas due to oil flooding the beaches, etc.

#### **D.**

The Deepwater Horizon opened a multitude of contingencies for BP. Most of those had to be estimated due to the nature of the incident being an oil spill, which spans over a large area. Most of the estimates would be estimating losses due to losing lawsuits against people who were negatively affected financially and were seeking reparations against BP. Other contingent liabilities could arise from environmental organizations seeking payments for the detrimental impact that the oil spill had on the environment. BP and the auditors and lawyers would have to estimate all of these amounts to the best of their ability, so that they could faithfully represent those liabilities to the users of the financial statements. Another cost that BP would have to estimate is the administrative costs that would arise with dealing with complaints, directing those complaints to the right people, and the time spent dealing with grievances against BP instead of performing normal operations.

#### **D+.**

As an auditor of BP, working with the lawyers would be a frightening task, as there are so many angles from which people or entities have grounds to sue BP. First and foremost, looking at the companies that were largely dependent on the good standing condition of the water would be a priority. A few examples of such companies would include tourism agencies such as hotels, motels, retail outlets, and restaurants located in areas affected by the oil spill. They would be entitled to compensation because of the

decrease in tourism to areas that depend on that tourism to generate income. Another priority would be those people suing for environmental damages, such as damage to the coastline, wetlands, wildlife, or other harm to the ecosystem in the Gulf region. Other companies affected would be larger scale fishing companies located in the Gulf of Mexico, because of the increased difficulty of fishing in that area. Lastly the families of those injured or those who perished in the destruction of the oil rig itself would be entitled to compensation if they were to file a claim., as well as those injured or putting themselves at health risks from cleaning up the aftermath of the spill.

There are several industries that would not truly have a case against BP, such as banks, insurance firms, or developers of land. Shareholders would not truly have a case against BP, unless they were directly affected by the oil spill, because they knew the risk of the value of the shares dropping when they initially invested in the company.

## **Case Nine: The Wendy's Company**

A Case Study About Equity Method Investments

Prepared By: Alex Watkins

April 3, 2019

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## **9.1 Case Introduction**

In this case we were tasked with navigating The Wendy's Company joint venture with Tim Hortons, otherwise known as TimWen. Through this case, we had to gain an understanding of why companies undertake joint ventures, how they account for them, and how to use the financial statements of the companies, as well as the footnotes, to analyze their various activities. This case helped will help me in the future for several reasons. First of which will be through my upcoming Advanced Accounting course in which I will be dealing with consolidations. This early exposure to this material will put me ahead of the curve in my preparation for that course. Secondly, if I were to pursue a career with the Big 4 (as are my intentions), I would be dealing with such mergers and acquisitions frequently.

## **9.2 Questions Answered**

**A.**

Companies enter joint-venture agreements as an alternative to a business merger or acquisition, so that each entity can retain their unique identities. This helps take out the large complexities of mergers, benefitting both firms. Joint ventures allow the businesses involved to pool their resources and work towards a common goal, or to reach a specific target market. Not only do the entities share the profits and losses involved with their venture, but they also mitigate the overall risk involved with the project at hand.

**B.**

The equity method of accounting is used when the investor is able to exert significant influence over the investee. "Significant influence" meaning that the investor is able to impose their will on the company through holding a bulk of the shares of a company. This is usually when they own 20-50 percent of the overall shares in the company, therefore outgunning other shareholders. When using the equity method, the original investment is recorded on the balance sheet. Any share of the profits that the investment gives to you will be recorded as an increase of the carrying amount of the investment, and any dividends they kick out will be recorded as cash received in the income statement, as well as a decrease to the carrying amount. The investee then records these adjustments in the other comprehensive income section. The investor accounts for it in this way because they truly care about the investment, due to the large contingency they have in it.

**C.**

When a company purchases shares in another company and the purchase price is greater than the book value of the underlying net assets of the company they are investing in, it creates an interesting accounting procedure. The excess amount paid over net assets dealt with by using a process called accounting acquisition premium. This procedure splits the excess amount into two categories: the identifiable assets and liabilities, and the goodwill paid. The company would write those assets and liabilities up to the fair value of the investment, and then they would be annually charged for depreciation under the equity method of accounting. The goodwill is kept on the books, not amortized, and tested annually for impairment. Impairment of goodwill occurs when the market value of the intangible assets drops below the acquisition costs of those assets. This impairment would result in a decrease of the goodwill account on the balance sheet, and a loss on the income statement.

**D.**

The equity in earnings from TimWen is included in “Other operating expense, net”. This represents the excess depreciation and amortization of assets that are in possession of Tim Horton have financial implications to Wendy’s. The carrying value of the investment is included on their consolidated balance sheets and consolidated statements of operations in the investment section under assets.

**E.**

The primary difference from the carrying value of the investment in TimWen and the underlying equity of the joint venture is mainly due to the purchase price adjustments from the Wendy's merger. This difference is known as acquisition accounting premium. The acquisition accounting premium is the excess value paid over the estimated fair value of the business at acquisition and is often referred to as "goodwill" on the balance sheet.

**F.**

i) The equity investment that The Wendy's Company has in TimWen caused an increase in their earning by a fraction of Wendy's actual share of net income in Tim Horton. This number is reflected as TimWen's 2012 "equity in earnings for the period" of \$13,680 in note 8 of the financial statements. Along with that is an amortization of the purchase price adjustments during the period, or \$3,129 in 2012. This reduces Wendy's 2012 earnings (before tax) to be \$10,551. The difference of the equity in earnings for the period in 2011 and the amortization of the purchase price adjustments is represented as earnings before tax, or \$10,571. All of these numbers can be found in other the "other operating expense" section of Wendy's consolidated statements of operations but are expanded in note eight.

ii)

dr. Equity Investment in Joint Venture—TimWen 13,680

cr. Equity Investment Income 13,680

iii) 2012 Journal Entry:

dr. Equity Income 3,129

cr. Equity Investment in Joint Venture—TimWen 3,129

Amortization of the purchase price adjustments in 2012 was reported in note eight as \$3,129. The number was based on the original aggregate life of 21 year.

iv) 2012 Journal Entry:

dr. Cash 15,274

cr. Equity Investment in Joint Venture—TimWen 15,274

Wendy's received \$15,274 in dividends during 2012 and \$14,942 in 2011. These figures can be found in the notes to the financial statements under note eight as "Distributions received".

**G.**

i) There was a negative adjustment made to arrive at net cash from operating activities to adjust for the portion of earnings that were already being included in net income. The equity income is included in total income, but no cash payment was received for the increase in value of the investment. The only cash that was paid was from dividends, which is not included in net income. The loss from the joint venture in Japan of \$1,827 will be deducted from the equity investment earnings (before tax) of \$10,551 to arrive at the negative adjustment of \$8,724 for “Equity in earnings in joint ventures, net” during 2012.

ii) Similar to “part i” of this question, dividends received are not included in the net income number (they were received in cash), as they were recorded as a deduction of the value of the equity investment in TimWen. To represent the correct cash amount in the consolidated statement of cash flows, there had to be a positive adjustment for the distribution of dividends received from the TimWen joint venture of \$15,274.

## **Case Ten: Johnson & Johnson**

A Case Study About Retirement Obligations

Prepared By: Alex Watkins

April 10, 2019

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### **10.1 Case Introduction**

This case took a look at Johnson & Johnson's retirement plans. Retirement plans are valuable tools offer valuable benefits to employees after their retirement based on a number of factors that vary depending on what type of plan is offered. Offering such retirement plans incentivize employees to continue working diligently for a company. Through the course of performing this case, I was granted more knowledge as to how the different aspects revolving around pension plans are represented on a company's financial statements. Not only that, but I was able to analyze individual components of pensions to gain a better understanding of such benefit plans. I feel this case will value me in the future through giving better clarity as to how to companies report dealings with pension obligations and plan assets.

## **10.2 Questions Answered**

**A.**

- i) The two types of retirement (pension) plans are known as defined benefit plans and defined contribution plans. Both of these plans differ from each other and offer different benefits to the employees of the company. A defined benefit plan is one in which a retirement account is set up for the employee, and the employer is the only one who contributes a promised amount to the employee, who then begins to get the payout when they retire. A defined contribution plan, on the other hand, is one in which the employee has to make payments to the plan, which are usually matched by the employer.
- ii) Retirement plan obligations are classified as liabilities for companies that have such plans because, although the pension plan is an investment, the retirement plan obligation represents money that will eventually be paid to employees that engage in such plans. At retirement, an employee will be paid benefits from the plan asset account, and the retirement plan obligation is reduced to reflect the benefits paid. (*flowchart found at the end of the document*)
- iii) There are several assumptions that are necessary in order to account for retirement plan obligations. An example of one is assumptions made by actuaries about the expected life of the employee after retirement. Depending on the type of plan, this can affect how much money will be paid out to them. Another assumption that must be made is an

assumption about future salary increases, decreases. If left unaccounted for, a nonfaithful representation of the obligation attributable to the employers may occur.

**B.**

Companies' pension obligations are influenced by four main activities: service cost, interest cost, actuarial gains or losses, and benefits paid to retirees. Service cost represents present value of retirement benefits earned by an employee from them continuing to work another year. Interest cost represents the interest that accumulates on the unpaid balance of the projected benefit obligation. Actuarial gains or losses originate from change in life expectancy or market volatility. If an actuary estimates that the average life expectancy for an individual goes up, then the employer will have to account for that by increasing their projected benefit obligation due to the fact that they will have to continue to pay employees for a longer period of time, and by recognizing prior service cost. Benefits paid to retirees is the amount of money that the employer actually pays out to the employees during the year, which reduces the obligation.

**C.**

The three main components that affect plan assets are: actual return on plan assets, company contributions to the plan, and benefits paid to retirees. Actual return on plan assets is the money that your pension plan earns through interest, dividends, and capital gains generated by the assets within the pension fund. Return on plan assets reduces the company's pension expense and increases the value of their plan asset.

Company contributions to the plan is the money that comes out of the company's pocket to fund the plan asset. Such contributions reduce cash and increase plan assets. Lastly, benefits paid to retirees are paid out of the plan asset account, reducing the overall retirement plan obligation.

**D.**

Both pension expense and pension plan assets have a "return on plan assets" component. The two returns differ because return on plan assets reduces your pension expense and the opposite for plan assets. This is due to the fact that if you are getting a return on your pension plan, you can offset that against expenses generated from the pension plan. Pension expense also uses the expected return in order to reduce market volatility in the income statement, bolstering investor confidence.

**E.**

Other benefits plans, such as healthcare and insurance benefit plans, differ from retirement plans, because other-benefit plans affect the employee during the span of their employment. Retirement benefit plans, besides the periodic payments by employees under certain pension plans, do not affect the employee until after they have retired, in which they are paid the money that they earned during their service to the company.

**F.**

i) Johnson & Johnson reported \$646 million as the pension expense in its consolidated earnings statement for 2007. To gain better insight as to how the components of pension expense are accounted for, see the following journal entries made to record \$597 million of service cost and \$656 million of interest cost in 2007.

ii) Entry to record service cost:

Pension Expense	597,000,000
Projected Benefit Obligation	597,000,000

Entry to record accrued interest on PBO:

Pension Expense	656,000,000
Projected Benefit Obligation	656,000,000

**G.**

i) Page 62 of Johnson & Johnson's annual report details its retirement plan obligations. In 2007, the retirement plan obligation had a balance of \$12,002 million. This value represents how much the company owes to its employees through retirement benefits. Although this number fluctuates periodically due to actuarial assumptions, it is usually a fairly reliable number.

ii) The pension related interest cost, also shown on page 62, was \$656 million in 2007. The average interest rate used by Johnson & Johnson was 5.63 percent. This, when compared to the average interest rate of the U.S. for interest obligations (5.85 percent), is a very reasonable number.

iii) Throughout the year of 2007, Johnson & Johnson paid pension benefits of \$481 million. These benefits were paid through a reduction of the plan assets held by the company, not using cash. This payment of benefits reduces the overall projected benefit obligation as well as plan assets.

#### **H.**

i) As seen on page 62 of the annual report, pension plan assets (as of 12-31-07) were valued at \$10,469 million. This “value” represents the estimated fair value of the underlying assets held in the plan asset memo account at the end of the year.

ii) It is important to keep up with the difference between expected and actual return on plant assets, so that actuaries can adjust their estimates appropriately. In 2006, Johnson & Johnson expected to receive a return of \$701 million, and actually received returns of \$966 million. In 2007, they expected returns of \$809 million, and received actual returns of \$743 million. There was an excess of actual return over expected of \$265 million in 2006, which would be recorded as a gain under other comprehensive income. In 2007, there was a shortage actual return under expected return of \$66 million, which would be reported as a loss under other comprehensive income. In my opinion, this difference is material as the numbers are very large. I believe that actual return is a better reflection of the economics of Johnson & Johnson’s pension expense, due to the fact that it is not an approximation whereas the expected return is based on estimated numbers.

iii) In 2007, Johnson & Johnson along with participants in the pension plan contributed \$379 million. In 2006, they only contributed \$306 million. Therefore, there was \$73 million more contributed in 2007 than 2006.

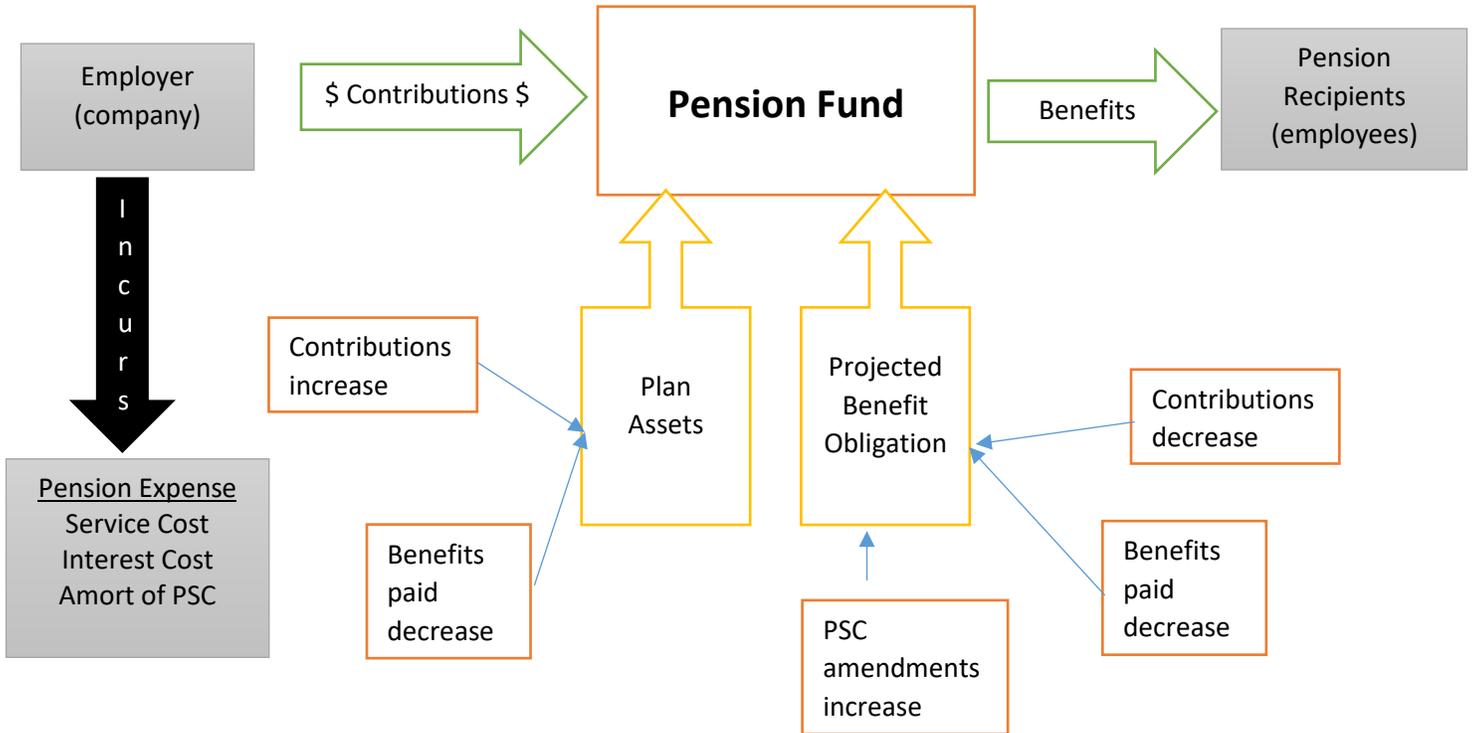
iv) Johnson & Johnson's retirement plan assets are held as equity and debt securities, of which 67 percent are equity, and 32 percent are debt securities. The remaining one percent is held in real estate and other investments.

**I.**

In 2006, the company's retirement plan is underfunded by \$2,122 million, and in 2007, the plan is underfunded by \$1,533 million. These figures can be identified by the negative balance in the "Fund status at the end of year" line, in the change in plan assets section.

### 10.3 Flowchart

Figure 10-1: Pension Fund Flow Chart



## **Case Eleven: On Balance Sheet-Based Model of Financial Reporting**

A Case Study About the Balance Sheet vs Income Statement Approach to Reporting

Prepared By: Alex Watkins

April 15, 2019

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11.2 Questions Answered.....	97

## **11.1 Case Introduction**

For this case, we were tasked with reading an article that analyzed the current Balance Sheet Approach of accounting and pointed out its pitfalls and potential future consequences. Through reading this article, I learned many things about how FASB came to the original decision to use this method over the Income Statement Approach, which the author of this article argues is a much better approach to financial reporting. This article highlighted the reasons that the author felt this way in great detail, giving several reasons and expanding on those reasons throughout the article.

By reading this article, I am much more informed about the current state of financial reporting, as well as an alternate method that goes values Income Statement items more highly than ones that appear on the Balance Sheet. I now have a much broader perspective on the pros and cons of each and will be able to take this knowledge with me into my future career as an accountant.

## **11.2 Questions Answered**

### **a) Provide a Summary of the Article**

This article is an overview of the author's perspective of how FASB and the IASB should consider changing the framework of financial reporting from a balance-sheet approach to one that emphasizes the importance of the income statement approach. In 2007, FASB was reconsidering their conceptual framework, with major components and concepts such as "assets, liabilities, revenue recognition" being on the table of discussion. Our author believes strongly that financial reporting should "reflect business reality", and that through the current methodology of utilizing the Balance Sheet Approach, FASB has created a situation where this is not true. Four main critiques are given, and I will list and expand on each of them in the following section. After the author critiques the Balance Sheet based model of financial reporting, he/she offers a pair of solutions to help remedy this issue.

The first critique our author has to offer is that the Balance Sheet Approach is problematic because it is at odds with how most businesses operate, create value, and are managed. According to the author, assets are just props that serve the continual stream of company operations and have little independent existence and value. He/she used a metaphor that truly resonated with me, one that compared companies to "asset furnaces", where companies hold and use up the assets to generate income/earnings. Assets are temporary implements to carry out business operations and are usually dissolved after the

project is completed and the money is made. With the current approach, companies could be viewed as an “asset greenhouse” where the company “grows” their assets to earn money. Managers, when envisioning a new product line, do not visualize the main source of added value to be the asset buildup that comes alongside creating the product line, but rather the revenues that the newly acquired assets would generate (as well as the costs of obtaining such assets). Therefore, accounting should reflect the reality of firms operating through a process that advances expenses to earn revenues, with assets having a secondary and supporting role.

The second critique goes on to mention how FASB claims that the Balance Sheet Approach has a logistical and conceptual superiority over the income statement approach, and how the author believes this not to be true. The author references FASB’s definition of an asset, which can easily be compared to the definition of earnings. Furthermore, assets and income are significantly connected, if not indistinguishable. FASB claims that the concepts of income and asset can be separated, and that one can be made “superior” to the other. Assets are becoming increasingly difficult to value with the increased prominence of intangible assets and goodwill. For example, it is much easier to identify how much income a company has made compared to valuing all of its assets.

The third point makes a critical assertion that if the methodology is not changed, it will have significant and detrimental effects on the usefulness of earnings. The increased requirement and creation of valuation accounts and other related “one-time”

changes on the balance sheet is decreasing the accuracy of current earnings being able to predict future ones, which is a quintessential measure for investors (the primary users of financial statements).

Lastly, the author points out that there are many problems with applying the Balance Sheet based model of accounting in practice. An example of such problem would be “mark-to-market” accounting, where a company can revalue their asset based on the market value, if no value is easily determinable. An extreme case of this is represented with the rise and fall of Enron through their accounting scandal. Fair Value accounting puts a lot of faith in market prices and elevates them into an unfailing standard of correctness, when this may not always be the case.

**b) How did this article change your current way of thinking?**

This article had a significant impact on how I view financial reporting. First and foremost, I was not fully aware of how heavily FASB emphasizes the use of the Balance Sheet Approach in financial reporting. This article enlightened me to the fact that the essence of the Balance Sheet approach is that the proper valuation of assets and liabilities is the primary goal of financial reporting, and other accounting variables are considered secondary and derivative. This greatly underplays the importance of earnings, as the author greatly emphasizes. I also learned more about the income statement approach, which the author is very fond of. The Income Statement Approach views the determination of revenues, expenses, and earnings as the primary goal of financial

reporting. This method highlights the revenue recognition principle and the matching of revenues principle. I agree with the author's assertion that the Income Statement Approach is superior in this case, as he/she evidences the fact the investment community values earnings as a measure of performance much higher than the determination of assets and liabilities. Investors base their decisions mainly off of income statement considerations rather than balance sheet considerations. This accurate depiction of earnings, according to our author, is at high risk of becoming a diluted figure with no true meaning. This is due partially to the fact that FASB requires the creation of valuation accounts on the balance sheet in certain situations, which in turn decreases the accuracy of the "earnings" figure.

My current way of thinking was also changed starkly from the metaphor used to depict the using of assets to derive earnings. I feel as though this was the strongest point made, as companies truly make substantially more earnings from the use of their assets rather than selling those same assets for profit. It seems as though FASB kind of runs in circles with their point that you can only define earnings once you know how to define those earnings. This was pointed out by the authors through the explanation that it is difficult to separate an asset and the income derived from that asset. FASB claims that the Balance Sheet Approach has conceptual superiority over the Income Statement Approach, but our author debunked that theory for us and consequently changed the way I thought about it.

The last way my eyes were sort of opened to the pitfalls of the Balance Sheet approach stemmed from the increased reliance of the asset's fair value in the valuation of company's assets. The fair value of an asset and the value of the asset to the company can differ starkly, which creates a problem in itself for the "mark to market" method of accounting. This leads to an unfaithful representation of the correct values of certain assets listed on a company's balance sheet.

I appreciated the fact that the author points out, at the end of the article, that an overhaul of the model of financial reporting is a task that would take many years and a lot of resources to accomplish, and that the observations made were offered more to spark a debate than to offer a solution.

**c) How will you use this information in your future career?**

This information will be extremely useful to me not only in my future career, but also currently. Now that I know that more than one approach to financial reporting could exist, and that the one currently in place is one based off of rather old and outdated information, I can move forward with a broader perspective. Before the existence of FASB, the Accounting Principles Board and many accounting theorists relied heavily on the Income Statement Approach as a guiding theory. This way of thinking was dominant until the mid-1970s according to our author. Going forward in my career, it is a great thing that I now know that such changes could arise in the near or distant future, and that those changes would fundamentally change the field of accounting.

The discussion of the dissolution of the importance of the concept known as earnings is one that was very concerning to me. Our author claims that the earnings currently being reported under the balance sheet approach are not what would be considered “good earnings” by investors, and that a lot of damage has already happened over time due to this fact. Over the past 40 years, earnings volatility has doubled, while at the same time earnings persistence has fallen. The author attributes this not to a change in the underlying revenues, expenses, or cash flows of companies, but rather to changes in accounting principle. I can use this information to my benefit by knowing to not just trust numbers reported by different entities, but to actually delve into the financial statements myself to find out the truth.

Lastly, and what I think to be the most important thing that I gathered from this article that will be applicable to my future career is that although FASB requires and relies on a Balance Sheet Approach to financial reporting, I should not always trust the numbers and figures that come from this method of reporting. In my future career, I will now know to not only utilize the balance sheet, but to give equal consideration to the income statement as well in disseminating information about an economic entity. More specifically, I should not rely too heavily on the fair market value of certain assets, as they do not always represent the value that should be derived from the asset.

## **Case Twelve: Google Inc.**

A Case Study About the Earnings Announcements and Information Environment

Prepared By: Alex Watkins

April 28, 2019

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### **12.1 Case Introduction**

This case asked us, from an investor's point of view, to analyze Google's use of non-GAAP financial reporting measures and justify why and how they go about doing that. Using the reported materials, the earnings press release, and outside sources on the internet, I found out a lot about how earnings can have an impact (or lack of one) on a publicly traded company's stock price. How the general public reacts to a company's form of accounting, or even simply an alternative method of financial reporting, is directly related to stock price from my findings.

Through completing this case, I feel as though I have gained valuable insight as to how to analyze a company and identify the correlation between financial performance and outside factors (such as a press release) and apply that to investing or accounting. I now know that accountants must be very meticulous when it comes to financial reporting, as there is high volatility in the investing market.

## **12.2 Questions Answered**

**H.**

ii) After reviewing the table that reconciles the GAAP measures to Google's use of non-GAAP measures to report net income and earnings per share, I believe that the way that they went about excluding certain expenses from their net income was fair. The justification that Google gave for recording and presenting non-GAAP measures included that they use those figures for financial and operational decision-making, as well as means to evaluate period-to-period comparisons to past periods, and other similar companies. This holds true, as although stock-based compensation is a recurring charge, its effect on net income will fluctuate greatly from period to period and does not technically reflect the company's operating performance. Many analysts across the board do not even take stock-based compensation into effect when evaluating a company, so Google expedited this process for them, and reported it themselves.

Google more than likely is a big fan of presenting these non-GAAP financial measures, as evidenced by the significant margin between what they reported under GAAP measures. For example, GAAP operating income for the fourth quarter of 2013 was \$3.92 billion (23 percent of revenues), whereas non-GAAP operating income for the same quarter was a whopping \$920 million dollars more at \$4.84 billion (29 percent of revenues). This boost to the amount of income isn't strictly from the exclusion of stock-based compensation, however. Included in that exclusion is costs of restructuring and

related charges, as well as the related tax expense for those items. Because of the fact that restructuring charges are not a frequent occurrence in the business, Google felt that including those expenses in their financial measures would not be a good representation of financial performance for comparison purposes.

## **I.**

i) Generally speaking, an increase in a company's earnings will help raise the overall earnings per share value of a publicly traded company. Such is the case in Google's situation, whereas their earnings across each quarter fluctuated, the stock price followed suit. The best depiction of this is after the Q3 earnings were released. You can visibly see the jump in stock price due to the increase in reported earnings.

ii) Compared to the NASDAQ index, which represents the performance of a broad set of firms that are publicly traded on the stock market, Google's stock value consistently outperformed the index, only dropping below in January 2013 and briefly in October 2013. Again, after the huge jump in Q3, Google's stock price stayed far above the NASDAQ index for the rest of the reported period.

iii) Initially, after the release of the earnings news, it seems the investors did not take the news in a good sense, as the value of the stock dropped from around \$1,170 down to around \$1,100. After a month, however, it seems as though the fluctuation was self-correcting as the price of the stock reached above even where it was before the press release.

**J.**

- i) According to the Wall Street Journal article, the revenue of \$16.9 billion was higher than the \$16.8 billion that analysts had been projected for that period. “Investors seem happy”, claims the journal, despite the “disappointing” bottom line results. This is reflected in the increase in stock price following the Q4 press release.
  
- ii) Other factors that might contribute to the positive reaction following the press release include the sales via the Google Play store on Android smartphones. These sales numbers were a “key reason for strength” in the company’s other revenue line, according to executives within the company. Also, the sale of Motorola to Lenovo excited analysts, as a “potential distraction” was eliminated, while boosting Google’s bottom line at the same time. The only thing I could see investors being concerned about is the fact that analysts, on the basis of non-GAAP measures, predicted earnings per share to be 19 cents above what it actually was.

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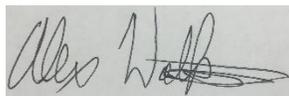
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**“On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this thesis”**

**Signature:**

A handwritten signature in black ink on a light gray background. The signature appears to be "Alex Wolf" written in a cursive, slightly slanted style.