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CASE STUDIES IN FINANCIAL ACCOUNTING

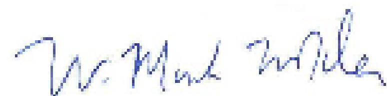
by
Ian Ulmer

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

Oxford
May 2020

Approved by:

Advisor: Dr. Victoria Dickinson



Reader: Dean Mark Wilder

ABSTRACT

Ian Ulmer: Case Studies in Financial Accounting

The following thesis is intended to examine topics currently faced by accountants in the profession, in the areas of both technical proficiency and ethical theory, with an eye towards addressing potential areas of interest for accountants in the coming years. These case studies consist of established academic cases that use issues encountered and documented by several of the largest companies in the world to teach accounting theory, as well as cases in development by faculty of the Patterson School. These cases are designed to allow students to apply their previously theoretical knowledge of GAAP to case studies that document real-world business events, with all of their inherent complexities, as well as to consider several less technical aspects of the accounting profession that may not be as emphasize in the coursework of the typical Accounting degree path. This thesis is intended to be the final product of the Accountancy Honors Thesis Course, which addresses all aspects of the Accountancy academic program, including the preparation of financial journal entries, research on established and emerging topics in accounting, and the analysis and interpretation of financial statements.

This thesis was prepared as part of the Accy 420 course, under the direction of Dr. Victoria Dickinson of the Patterson School of Accountancy, during the 2018-2019 academic year.

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Case Study #1

Data Analytics Programs

September 12, 2018

I. Introduction

The purpose of Case Study #1: Data Analytics is to provide an in-depth examination of the programs available to accountants to improve the efficiency with which financial data is processed and analyzed, in the course of executing their professional obligations. The case concerns eleven distinct data analytics programs, but this analysis will be limited to one specific program, SAS, formerly the Statistical Analysis System, developed by the SAS Institute. The following analysis will examine the origins of the SAS suite of products, the purpose for which it was created, and its potential applications to business entities, both in the specific field of accounting and in the wider business environment. Ultimately, the analysis will conclude with a recommendation, by the author, to a hypothetical employer for, or against, the investment of firm resources in the acquisition and implementation of the SAS program, based upon the merits of the program and its potential value to the firm.

For accounting students quickly approaching entry into the labor market, the value of this case study lies in the familiarity that it imparts with digital tools and software that are either already widely used in the accounting profession or are quickly becoming essential parts of daily firm operations. In an industry that is, increasingly, pivoting towards technological solutions to create greater efficiency and accuracy in the operations of the company, proficiency with these established analytics programs will impart a newly employed graduate with the tools and skills necessary to create value for their firm and advance their careers, as well as providing a strong foundation upon which to utilize and understand the applications of programs that will be developed and deployed in accounting firms, in the future.

II. SAS and its Applications

What is the purpose of the SAS program, and how is it used to make business decisions? The purpose of the SAS suite of data analytics programs is to provide a comprehensive program that organizes and

analyzes large quantities of data. The program categorizes and filters raw data, input by users, and provides a number of functions related to the analysis of the data, including identification of past trends, detection of outlier data, and the ability to create model predictions of future events, based on multiple variable inputs. Put simply, the SAS program allows for greater efficiency and reduced error in the analysis of significant quantities of present and past data, while also providing users with modeling programs to predict the outcome of any number of future variables.

How would the SAS program be used in Auditing? One of the purposes of an audit is to verify the effectiveness of the internal controls of the audited company. Whereas, previously, verification of a company's records was done by the selection and examination of individual accounts, the advent of data analysis programs, such as SAS, allows for the input of the entirety of audited company's data. In a specific example of SAS's potential application to an audit, take the situation of a company that suspects fraudulent transactions occurring in one of their departments. The pattern-recognition and machine learning software coded in the program allow for the recognition of outlier transactions or points of data as the program sorts through the company's information and can alert the auditor to the potential suspect transaction. Another potential application for auditors is the utilization of SAS's pattern-recognition technology to verify that a company is following revenue recognition principles. SAS will be much more efficient than a single auditor at scanning company records and combing through the web of transactions in a company's ledger to determine if a company is accurately matching revenues with the associated period, in accordance with GAAP, or if the given company is altering records to, for example, meet a revenue target for a particular period. The SAS software's potential applications in the field of accounting, however, are not strictly limited to its use in the auditing of a client's company. Accountants performing internal audits on their own companies or divisions will find the SAS suite of programs useful, as well. Take, for example, the case of an accountant, for a retailer, tasked with performing a review of the company's Receivables accounts. The SAS software could be used to analyze the

Receivables accounts and search for a variety of factors, such as a potential pattern of customer product returns that is indicative of a wider warranty issue with one of the company's products. Early warning of such an issue may allow company executives to ameliorate the issue, or to revise company revenue projections for the period, in anticipation of the impact of a large number of product returns on quarterly revenues.

How would the SAS program be used for Tax Planning? The purpose of accounting, for tax planning purposes, is to aid the client in paying the legal minimum in taxes, and, considering the multitude of variables that go into predicting a client's tax liability, any program that aids the tax planner in organizing all of the data, in one location, would be invaluable. One of the strengths of the SAS program is the user-friendly modelling program, which takes the data input and creates a predictive model, based on the selection of multiple variables, which are chosen by the user. For example, an accountant working with a multi-national corporation to reduce their tax liability may input the company's sales data into the model, using tax information for various countries that the corporation operates within, as a variable. The resulting model could be used to cross-reference areas of growing market demand for the company's product with areas that have a tax environment favorable to the client, indicating a strong potential opportunity for expansion in a favorable region that would result in minimal tax liability. Another potential use of the SAS software for tax planning purposes is the analysis of historical trends; a tax planner looking to estimate future tax liability for a client may use the pattern-recognition and modelling capabilities of SAS to analyze the client's past financial data, coupled with projections of future changes that may affect tax liability, such as a potential change in federal corporate income tax rates, to assist the client in preparing a reasonably accurate prediction of future tax liability. From a practical standpoint, the software also has the potential to reduce the likelihood of accidental omissions on corporate tax documents, as all of the information, regarding a company's financial dealings, will be located in one program, lessening the likelihood that a critical omission will be made. The prevention of

even minor errors will save the client significant time and monetary resources that, otherwise, would be occupied by correcting the mistake.

III. Recommendation

After spending time researching the potential utility of the SAS suite of data analytics programs, I would recommend that the firm invest in the acquisition of SAS and in the training of personnel to properly utilize the features of the program. The benefits of the system far outweigh the cost to license and implement it within the firm. Whether it is used for external auditing, tax planning, or internal control purposes, SAS has the potential to drastically increase the efficiency of the processing and analysis of raw data within the firm, freeing up employee time and company resources to be applied towards more productive work. Rather than spending valuable time combing through the entirety of a client's financial records and transferring raw data from the financial records to an organized file, then inputting this collated information into a separate modelling software, employees of the firm will be trained to efficiently utilize the resources of the SAS program to perform labor-intensive data analysis much more effectively than before. The SAS program will also aid in the coordination of multiple employees working on a single task, as the program can be run concurrently, by different users, and all of the work done on the platform can be viewed and monitored by a central administrator, giving senior employees oversight over team projects or groups of new hires.

Another significant incentive for the firm to invest in the SAS software is the simple fact that many of the firm's potential customers use it, as well. For example, many of the world's largest banks utilize SAS in some capacity, making the acquisition of the program a practical investment for firms that do significant business with companies in the banking sector. Having employees trained and familiar with the software that clients use will aid the firm in providing performance satisfaction to the client and executing the responsibilities of the firm with maximum efficiency.

My recommendation to the firm is that it invests in the SAS suite of programs because it provides more efficient and accurate means of data management and analysis, a platform to coordinate large-scale projects, and an increased ability to evaluate and analyze client data, ultimately providing greater service to the client.

Ian Ulmer

Case Study #2

Rocky Mountain Chocolate Factory

Preparing Financial Statements

September 5, 2018

Ian Ulmer

Case Study #2

Rocky Mountain Chocolate Factory, Inc.

Summary:

The purpose of this Case Study was to examine the process by which a company moves through the stages of the accounting cycle, from identification of transactions to the posting of the closing entries. The use of Excel, as the medium for the case study, encourages an understanding of one of the most common means of collecting and organizing financial data that the average company will use, on a daily basis. Throughout the course of the case, we learned to use the Excel program to simplify the task of organizing and computing the financial information necessary to carry the transactions of a company all of the way through the accounting cycle.

Concepts: Part A

For Rocky Mountain Chocolate Factory, I would expect to see the standard balance sheet accounts for a retail corporation: Cash and Cash Equivalents, Inventory, Property, Plant, and Equipment, Accounts Receivable, Accounts Payable, Common Stock, and Retained Earnings, among others. The major assets of the company would consist of Cash/Cash Equivalents Property, Plant, and Equipment, Inventory, and Accounts Receivable. The major liability accounts will, most likely, consist of Accounts and Notes Payable, Accrued Expenses, and Accrued Wages.

Process: Part E

The Adjusting Entries that I would anticipate a need for would be an adjusting entry for depreciation expense, an adjusting entry to accurately reflect end-of-period inventory levels, and an entry to reclassify unpaid wages expense as wages payable.

	Beginning balance (February 28, 2009)	1. Purchase Inventory	2. Incur Factory Wages	3. Sell Inventory for Cash and on Account	4. Pay for Inventory	5. Collect Receivables	6. Incur SG&A (Cash and Payable)	7. Pay Wages	8. Receive Franchise Fee
Cash and Cash Equivalents	$ 1,253,947.00			$ 17,000,000.00	$ (8,200,000.00)	$ 4,100,000.00	$ (2,000,000.00)	$ (6,423,789.00)	$ 125,000.00
Accounts Receivable	$ 4,229,733.00			$ 5,000,000.00		$ (4,100,000.00)			
Notes Receivable, Current	$ -								
Inventories	$ 4,064,611.00	$ 7,500,000.00	$ 6,000,000.00	$ (14,000,000.00)					
Deferred Income Taxes	$ 369,197.00								
Other	$ 224,378.00								
Property and Equipment, Net	$ 5,253,598.00								
Notes Receivable, Less Current Portion	$ 124,452.00								
Goodwill, Net	$ 1,046,944.00								
Intangible Assets, Net	$ 183,135.00								
Other	$ 91,057.00								
Accounts Payable	$ 1,074,643.00	$ 7,500,000.00			$ (8,200,000.00)				
Accrued Salaries and Wages	$ 423,789.00		$ 6,000,000.00					$ (6,423,789.00)	
Other Accrued Expenses	$ 531,941.00						$ 3,300,000.00		
Dividend Payable	$ 598,986.00								
Deferred Income	$ 142,000.00								$ 125,000.00
Deferred Income Taxes	$ 827,700.00								
Common Stock	$ 179,696.00								
Additional Paid-In Capital	$ 7,311,280.00								
Retained Earnings	$ 5,751,017.00								
Sales	$ -			$ 22,000,000.00					
Franchise and Royalty Fees	$ -								
Cost of Sales	$ -			$ 14,000,000.00					
Franchise Costs	$ -								
Sales and Marketing	$ -						$ 1,505,431.00		
General and Administrative	$ -						$ 2,044,569.00		
Retail Operating	$ -						$ 1,750,000.00		
Depreciation and Amortization	$ -								
Interest Income	$ -								
Income Tax Expense	$ -								

9. Purchase PPE	10. Dividends Declared and Paid	11. All Other Transcations	Unadjusted Trial Balance	12. Adjust for Inventory Count	13. Record Depreciation	14. Wage Accrual	15. Consultant's Report	Preclosing Trial Balance	16. Closing Entry	Post-Closing (Ending) Balance	Actual February 28, 2010 F/S Figures
$ (498,832.00)	$ (2,403,458.00)	$ 790,224.00	$ 3,743,092.00					$ 3,743,092.00		$ 3,743,092.00	$ 3,743,092.00
		$ (702,207.00)	$ 4,427,526.00					$ 4,427,526.00		$ 4,427,526.00	$ 4,427,526.00
		$ 91,059.00	$ 91,059.00					$ 91,059.00		$ 91,059.00	$ 91,059.00
		$ (66,328.00)	$ 3,498,283.00	$ (216,836.00)				$ 3,281,447.00		$ 3,281,447.00	$ 3,281,447.00
		$ 92,052.00	$ 461,249.00					$ 461,249.00		$ 461,249.00	$ 461,249.00
		$ (4,215.00)	$ 220,163.00					$ 220,163.00		$ 220,163.00	$ 220,163.00
$ 498,832.00		$ 132,859.00	$ 5,885,289.00		$ (698,580.00)			$ 5,186,709.00		$ 5,186,709.00	$ 5,186,709.00
		$ 139,198.00	$ 263,650.00					$ 263,650.00		$ 263,650.00	$ 263,650.00
			$ 1,046,944.00					$ 1,046,944.00		$ 1,046,944.00	$ 1,046,944.00
		$ (73,110.00)	$ 110,025.00				$ -	$ 110,025.00		$ 110,025.00	$ 110,025.00
		$ (3,007.00)	$ 88,050.00					$ 88,050.00		$ 88,050.00	$ 88,050.00
		$ 503,189.00	$ 877,832.00					$ 877,832.00		$ 877,832.00	$ 877,832.00
			$ -			$ 646,156.00		$ 646,156.00		$ 646,156.00	$ 646,156.00
		$ (2,885,413.00)	$ 946,528.00					$ 946,528.00		$ 946,528.00	$ 946,528.00
	$ 3,709.00	$ (1.00)	$ 602,694.00					$ 602,694.00		$ 602,694.00	$ 602,694.00
		$ (46,062.00)	$ 220,938.00					$ 220,938.00		$ 220,938.00	$ 220,938.00
		$ 66,729.00	$ 894,429.00					$ 894,429.00		$ 894,429.00	$ 894,429.00
		$ 1,112.00	$ 180,808.00					$ 180,808.00		$ 180,808.00	$ 180,808.00
		$ 315,322.00	$ 7,626,602.00					$ 7,626,602.00		$ 7,626,602.00	$ 7,626,602.00
	$ (2,407,167.00)		$ 3,343,850.00				$ -	$ 3,343,850.00	$ 3,580,077.00	$ 6,923,927.00	$ 6,923,927.00
		$ 944,017.00	$ 22,944,017.00					$ 22,944,017.00	$ (22,944,017.00)	$ -	$ 22,944,017.00
		$ 5,492,531.00	$ 5,492,531.00					$ 5,492,531.00	$ (5,492,531.00)	$ -	$ 5,492,531.00
		$ 693,786.00	$ 14,693,786.00	$ 216,836.00				$ 14,910,622.00	$ (14,910,622.00)	$ -	$ 14,910,622.00
		$ 1,499,477.00	$ 1,499,477.00					$ 1,499,477.00	$ (1,499,477.00)	$ -	$ 1,499,477.00
			$ 1,505,431.00					$ 1,505,431.00	$ (1,505,431.00)	$ -	$ 1,505,431.00
		$ (261,622.00)	$ 1,782,947.00			$ 639,200.00		$ 2,422,147.00	$ (2,422,147.00)	$ -	$ 2,422,147.00
			$ 1,750,000.00			$ 6,956.00		$ 1,756,956.00	$ (1,756,956.00)	$ -	$ 1,756,956.00
			$ -		$ 698,580.00			$ 698,580.00	$ (698,580.00)	$ -	$ 698,580.00
		$ (27,210.00)	$ (27,210.00)					$ (27,210.00)	$ 27,210.00	$ -	$ (27,210.00)
		$ 2,090,468.00	$ 2,090,468.00					$ 2,090,468.00	$ (2,090,468.00)	$ -	$ 2,090,468.00

Rocky Mountain Chocolate Factory, Inc.			
Income Statement			
For the Year Ended February 28, 2010			
Revenues:			
Sales		$ 22,944,017.00	
Franchise Fees		$ 5,492,531.00	
Total Revenues:			$ 28,436,548.00
Expenses:			
Cost of Sales		$ 14,910,622.00	
Franchise Costs		$ 1,499,477.00	
Sales and Marketing		$ 1,505,431.00	
General and Administrative		$ 2,422,147.00	
Retail Operating		$ 1,756,956.00	
Depreciation and Amoritization		$ 698,580.00	
Total Expenses:			$ (22,793,213.00)
Operating Income:			$ 5,643,335.00
Other Income and Expenses:			
Interest Income		$ 27,210.00	
Interest Expense		$ -	
Total Other Income and Expenses:			$ 27,210.00
Income before Income Tax Expense:			$ 5,670,545.00
Income Tax Expense:			$ (2,090,468.00)
Net Income:			$ 3,580,077.00
Basic Earnings per Common Share			$ 0.60
Dilluted Earnings per Common Share			0.58
Weighted Average Common Shares Outstanding			6,012,717
Dillutive Effect of Employee Stock Options			197,521
Weighted Average Common Shares Outstanding, Assuming Dillution			6,210,238

Rocky Mountain Chocolate Factory, Inc. Balance Sheet As of February 28, 2010		
Assets:		
Current Assets		
Cash and Cash Equivalents	$	3,743,092.00
Accounts Receivable	$	4,427,526.00
Notes Receivable, Current	$	91,059.00
Inventories	$	3,281,447.00
Deferred Income Taxes	$	461,249.00
Other	$	220,163.00
Total Current Assets	$	12,224,536.00
Property, Plant, and Equipment, Net	$	5,186,709.00
Other Assets		
Notes Receivable, Less Current Portion	$	263,650.00
Goodwill, Net	$	1,046,944.00
Intangible Assets, Net	$	110,025.00
Other	$	88,050.00
Total Other Assets	$	1,508,669.00
Total Assets	$	18,919,914.00
Liabilities and Shareholder's Equity		
Current Liabilities		
Accounts Payable	$	877,832.00
Accrued Salaries and Wages	$	646,156.00
Other Accrued Expenses	$	946,528.00
Dividend Payable	$	602,694.00
Deferred Income	$	220,938.00
Total Current Liabilities	$	3,294,148.00
Deferred Income Taxes	$	894,429.00
Commitments and Contingencies	$	-
Stockholders' Equity		
outstanding	$	-
Series A Junior Participating Preferred Stock, authorized 50,000 shares	$	-
Undesignated Series, authorized 200,000 shares	$	-
Common Stock, $0.03 par value; 100,000,000 shares authorized; 6,026,938 shares issued and outstanding	$	180,808.00
Additional Paid-In Capital	$	7,626,602.00
Retained Earnings	$	6,923,927.00
Total Stockholders' Equity	$	14,550,529.00
Total Liabilities and Stockholders' Equity	$	18,919,914.00

Cash Flow Identification

Transaction:	Classification:
1. The company purchased $7,500,000 of raw material inventory, on account.	Operating
2. During the year, the company incurred $6,000,000 of factory wages.	Operating
3. The company sold inventory that cost $14,000,000 for a total of $22,000,000. Of that, $17,000,000 was received in cash and $5,000,000 was on account.	Operating
4. The company paid $8,200,000 to suppliers for inventory previously purchased on account.	Operating
5. The company collected $4,100,00 of accounts receivable.	Operating
6. The company incurred Sales Expenses of $1,505,431, G&A Expenses of $2,044,569, and retail expenses of $1,750,000. They paid $2,000,000 in cash.	Operating
7. The company paid $6,423,789 to employees for wages that had been previously accrued.	Operating
8. Rocky Mountain Chocolate Factory received $125,000 in cash from new franchisees.	Operating
9. The company paid $498,832 for new property and equipment.	Investing
10. During the year, the company declared $2,407,167 of dividends on its common shares. They paid $2,403,458 during the fiscal year.	Financing

Ian Ulmer

Case Study #3

Ethical Considerations

September 12, 2018

I. Introduction

The purpose of this Case Study was to give students an idea of potential dilemmas that we may face as we continue to progress towards completion of our degrees and entrance into the workforce. While, at first glance, I didn't completely understand the value of examining situations like the ones discussed, the problems that the students in the scenarios discussed experienced could easily be experienced by myself in the next several years, and having put previous thought into how I would respond to such a situation will enable me to better respond to any professional dilemmas that I may face in the future.

II. Scenario #1

In the first scenario, a current student of the Patterson School, referred to as Student 1, is having a conversation with another student. Student 1 wants to finish their bachelor's degree with the Patterson School and then attend law school, in order to work for a law firm, practicing tax law. However, Student 1 also wants to pursue the senior accounting internship, despite knowing that they did not intend to pursue a job with the accounting firm that they would, likely, be interning with.

The central issue of Scenario #1 is whether Student 1 should pursue an internship with an accounting firm to fill out a law school resume. At first, I was of the impression that Student 1 was making a wise decision to pursue an accounting internship, as it would provide relevant work experience to the field of tax law, while maximizing the value that the student takes away from their undergraduate education. The argument was raised that, by taking an internship with an accounting firm, Student 1 was taking a valuable career opportunity away from a student that, more than likely, had the intention of going to work for an accounting firm, post-graduation. This was not an argument that swayed my opinion much, however, as the internship would, most likely, go to the most qualified candidate, and, if the most qualified candidate was Student 1, so be it.

As the debate continued, I realized that my initial judgement had been flawed, in that I was only looking at the situation from the prospective of the potential interns. I had not considered the perspective of the firm that Student 1 would be interning with during senior year. I assumed that the cost to the firm would be minimal, in the event of a failed internship, as the intern was not being paid a full salary and had been working for the company over the course of the internship. I assumed that the intern's work would cover much of the cost of the training received, but this was an error of assumption, made in ignorance of the true cost, to the firm, of recruiting interns and converting them into full employees of the company. As Dr. Dickinson informed the class, post-debate, it costs one of the Big Four firms approximately $175,000 to bring in a recruit and train them, an expense that the firm will not recoup for almost 3 years, should the employee stay that long. If the employee does not work for the firm for the minimum of 3 years, the firm loses money, which, in turn, makes the firm less likely to hire more graduates from the same program.

This context was vital to my approach to Scenario #1. Previously, I had no objection to Student 1 accepting an internship with an accounting firm, certain in the knowledge that they would not be working for that firm in the future. However, after learning the costs of a failed internship, and the wider impact that it has on the program that the failed intern graduated from, I concluded that Student 1 should not pursue the accounting internship. If a student accepts an internship, it is an imperative that the student represent their program with integrity and do all in their ability to repay the firm for the opportunity that the firm has extended, which Student 1 would not have done, if they did not deviate from their plans to attend law school and work for a law firm.

III. Scenario #2

Scenario #2 concerned a student that is unsure of what field of business that they want to enter, post-graduation. Students 1, 2, and 3 are all enrolled in the Patterson School and pursuing a B.A. in

Accountancy, but Students 1 and 2 are not interested in accounting, as a profession. Instead, they want to work in Investment Banking and Consulting, respectively. Student 3 questions why the two are not pursuing degrees specific to their desired careers, and this forms the central question of the scenario: if one were interested in a particular field, such as investment banking, would it not be more advantageous to pursue a degree in that specific field? Having considered investment banking, as a potential profession, I was aware some of the challenges that pursuing a career in investment banking entails. From a logistical standpoint, a student looking to study investment banking will encounter more difficulty in finding a program than will a student of accountancy. The educational path for potential investment bankers is much less defined than the path for accounting students, and this difficulty in planning a course of study can be a strong incentive to choose a more structured major, such as accounting.

In the scenario, one of the students makes the point that University of Mississippi has a world-renowned Accountancy program, while the School of Business, which contains the Banking and Finance degree program, is not as recognized. While a degree in Banking and Finance might be more relevant to pursuing a career in investment banking, the degree would not carry the prestige that a degree in accounting carries and would not afford the student as many opportunities as study in a nationally-recognized program such as UM's B.A in Accountancy.

Another significant advantage to obtaining a degree in Accounting, as opposed to Finance or another related business degree, lies in the versatility and portability of an Accounting degree. As has been emphasized countless times by professors, texts, and speakers, accounting is the language of business. An understanding of the accounting processes that underlie the daily operations of a business allows an accountant to move between many different fields of business.

As the Scenario was played out, Student 1 revealed that a recruiter for one of the larger firms had encouraged them to take an accounting internship regardless, as a means of exploring potential career options. This would seem to be an appealing option, but, upon further reflection, this situation reflects some of the potential problems encounter in Scenario #1. The recruiter encouraged the student to pursue an internship with their firm, regardless of the student's desire to work in a different field. This may be an attractive option to a student unsure of their desired career, as a representative from the firm is giving them the option, but the reality for the firm is not so simple. The recruiter's sole job is to recruit, and, in pursuit of an attractive candidate for an internship, the recruiter made an offer that the wider firm may not honor or agree with. The cost of a failed internship to the recruiter is zero, but the branch that the student would intern with would invest significant time and money into the internship, and, were the internship fail to translate to full-employment because the intern left to pursue a job in finance, the firm would lose money, and the firm's opinion of students from Student 1's program may be negatively impacted.

My conclusion in Scenario #2 is that Students 1 and 2 gain more benefit from study in a high-quality accounting program, such as the program at UM, rather than a subpar program in a field that more specifically aligns with the students' career goals. However, I disagree that Student 1 should follow the recruiter's advice. If Student 1 is committed to working in the field of investment banking and has no interest in working for an accounting firm, the student should not take an internship with an accounting firm, as it will cost the firm money and may negatively impact future employment opportunities for fellow students at UM.

IV. Scenario #3

In Scenario #3, a student reaches out to Dr. Dickinson and asks for advice regarding a potential change in location. The student obtained and completed an internship with a Big 4 firm in Washington, D.C.,

where they initially thought that they wanted to work, and has been offered a job in the D.C. office. One year after completion of the internship, the student has come to the conclusion that they still want to work for the same firm, but at the Dallas office, in their hometown, and asks Dr. Dickinson her opinion on the possibility of transferring the job offer to the Dallas office. Dr. Dickinson informs the student that there is no prohibition regarding requests to transfer to another office, but that the better course of action would be to spend time working at the D.C. office, and only request a transfer after having spent a period of time doing quality work in the D.C. office, which was responsible for training the student. The student responds that they have decided that Dallas is a better fit for them, and that they will be relocating to Dallas to work, even if that means giving up a job with the Big 4 firm that has extended a job offer.

The central question of this case is whether it is acceptable for the student to request a transfer, out of the office that provided them training, to another office, before having begun work as a full employee of the D.C. office. Through analysis of all the relevant factors, I will come to a conclusion regarding what action I feel that the student in question should take.

My analysis of Scenario #3 led me to conclude that, while there was no problem with the student *requesting* a transfer to another office, within the firm, that was not the most responsible course of action. Taking the facts of the scenario into account, along with the information about the costs of internships, it is my opinion that the best course of action for the student would be to accept the job with the D.C. office and to perform well there, for the minimum of three years, to repay the D.C. office for the cost of training and internship, before requesting a transfer to another office. By allowing the D.C. office to recoup their upfront costs before requesting transfer to the Dallas office, the student fully discharges any financial and moral responsibility to the office that trained them, while preserving the University of Mississippi's reputation with the firm for classes of prospective students, in the future.

V. Conclusion

In the initial discussions of the scenarios for this case study, most of my consideration revolved around the perspective of the student, which seemed to be a common stance among many of those involved in the debate. I did not give much thought to the impact that the various scenario's discussed would have on the firm. However, after Dr. Dickinson informed us of the costs that each of the firms incurs, to hire and train new recruits, and the impact that failed internships have on a firm's relationship with an accounting program, it has become clear that there is just as much at stake, if not more, for accounting schools and firms than there is for new accountants.

Being part of the Patterson School has provided a number of invaluable opportunities to meet and become familiar with firms that I may be employed by, in the future, but it's easy to overlook how much work it takes, on the part of the faculty of the Patterson School, to maintain good relationships with the firms and to continue to provide these opportunities. Considering all of the effort that goes into securing these opportunities, it is a student's responsibility to represent the school well, to perform well for the firm, and to reinforce the good reputation of the University of Mississippi, so that rising graduates of the School of Accountancy will have access to the same opportunities.

Ian Ulmer

Case Study #4

Accounting for Debt Securities and Impairments

September 26, 2018

I. Introduction

The purpose of Case Study #4: Accounting for Debt Securities and Impairments is to examine the issue of the impairment of debt securities and the GAAP guidelines that dictate the proper recognition of, and accounting for, impaired debt securities. This case will also examine how the handling of impaired debt securities may impact the financial disclosures of a company, and the degree that individual judgement plays in identifying, and accounting for, the impairment of debt securities.

The purpose of financial reporting is to give the users of the information an accurate picture of the position of the company in question, and one of the most important metrics of a company is the value of its assets, including debt and equity securities. For most assets, particularly tangible assets and equity securities, a fair value isn't complicated to ascertain, as there is a readily available market to draw a price from, but the fair value of debt securities can be more difficult to obtain due to issues like impairment. When I began this case, I could look up the value of a building or the price of a company's stock, but I knew nothing about how to value a debt security or judge potential impairment issues. Working through this case gave me a more thorough understanding of not just debt securities, but also the issues that can arise when attempting to assign a fair value to other intangible assets.

II. Requirements- Part 1

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

When determining a potential impairment loss, an Entity must determine whether the decline in fair value of the securities is due to credit losses or non-credit related economic causes, such as a change in interest rates or fluctuations in market activity, as stated in the case document. Generic Bank has determined that the decline in fair value of their securities is related to changes in interest rates,

therefore is not due to credit losses. In addition, the bank asserts that the terms of the bonds will not allow them to be settled for less than the amortized cost basis, indicating that the securities will recover their lost value if held until maturity.

Assuming that the unrealized losses are due wholly to non-credit factors and that the securities have the potential to recover their amortized cost basis in the future, the securities are only designated as impaired if the Entity has the intent to sell the securities or lacks the ability to hold them, as stated in ASC 326-30-35-10. If Joshua Winters makes the decision to sell the securities during 20x2, the securities are then subject to impairment, regardless of if the securities are not sold until the following period. Winters has selected 7 securities to sell to meet the liquidity needs of the bank, identified by the CUSIP tags: 003, 015, 025, 030, 067, 076, and 096. Per ASC 326-30-35-4, impairment is assessed at the individual level of each security, rather than as a portfolio. To determine which individual securities are impaired, we refer to ASC 326-30-35-1, which states, "An investment is impaired if the fair value of the investment is less than its amortized cost basis," (ASU 2016-13). Following these guidelines, of the seven securities considered for sale, five are impaired: 003, 015, 025, 030, and 076.

In conclusion, Generic Bank has an impairment loss on the sale of securities, with five of the seven securities considered impaired under ASU 2016-13.

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

Once again, operating under the assumption that the unrealized losses are due to changes in interest rates and that the securities have the potential to recover their value, it must be determined whether the Generic Bank has the intent/ability to hold the securities until they recover their value. CFO Joshua Winters is concerned about the impact that the sale of the seven securities, mentioned above, will have

on the perception of the Bank's intent/ability to hold the securities until the fair value has recovered. To make a conclusion regarding this issue, it is necessary to examine the specifics of the ASC statute that determine whether or not securities in this scenario are impaired. Per ASC 326-30-35-10, a security whose fair value has dropped below its amortized cost basis, due to non-credit factors, is considered to be impaired "if an entity intends to sell the debt security, or more likely than not will be required to sell the security before recovery of its amortized cost basis…" (ASU 2016-13).

Generic Bank has expressed the intent to hold the remaining securities in its portfolio, but it also advisable to examine the bank's *ability* to hold the securities. Generic Bank is categorized by the FDIC as 'Well-Capitalized,' meaning that it has a Total Risk-Based Capital Ratio, or ratio of Total Adjusted Capital to Risk Based Capital, of at least 10 percent (FDIC). Due to this high rating, several additional sources of liquidity are available to the bank, should the need arise, such as Fed funds and FHLB advances. The availability of alternate sources of liquidity, coupled with the adequate funds generated from the sale of the seven securities sold at the beginning of 20x3, should be sufficient to meet any additional liquidity needs that Generic Bank might encounter, without necessitating the sale of additional securities, below their amortized value.

Given Generic Bank's intent to hold the bonds until maturity, whereupon they will presumably recover their amortized cost basis, and their ability to meet liquidity needs without the need to sell more devalued debt securities, it is my conclusion that Generic Bank does not have an impairment loss on securities, other than that on the seven sold.

III. Requirements- Part 2

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

My answers to Requirements 1 and 2, from both the perspective of an external auditor and that of a bank regulator, will not change. After reviewing the facts of the case, the adjoining financial statements, and the FASB guidelines on debt securities and impairment, I concluded that Generic Bank incurred impairment losses on five of the seven securities that were chosen to be sold, based upon the definition of impairment in ASC 326-30-35-1. I also concluded that the bank did not incur impairment losses on the remaining securities in the portfolio, based upon the guidelines set forth in ASC 326-30-35-10. A shift in perspective, to that of an auditor or bank regulator, will not change my final conclusion, regarding Requirements 1 and 2, however, as a third-party investigator, there are several issues that I would consider, in greater depth.

The first factor that an auditor may examine more closely is Generic Bank's claims that the decline in the value of 55 of its debt securities, below amortized value, is due solely to changes in interest rates. One of the primary factors in the classification of a security as impaired is whether the decline in fair value is due to credit deterioration, on the part of the borrower, or is due to economic conditions, such as a change in interest rates. It is the responsibility of an auditor to examine such a critical claim, rather than to take it at face value.

A bank regulator, may, in the interest of ensuring that a bank is not in jeopardy of defaulting on its deposits, also take steps to verify that the loss of fair value on the 55 debt securities in question is not due to credit factors. However, it is likely that the bank regulator will be more concerned with Generic Bank's ability to cover its liabilities, namely client deposits, with existing resources, and the ability of the

bank to raise liquidity from external sources. Given that much of Generic Bank's ability to hold the securities until maturity, and the subsequent recovery of the fair value, is based upon its ability to raise liquidity from external sources, such as Fed Funds and FHLB advances, which is, in turn, based upon its classification as "Well-Capitalized" by the FDIC, a bank regulator may examine the other securities in the portfolio and reassess the risk contained therein. Were there to be a change in the bank's total risk-based capital ratio, it may limit Generic Bank's future ability to access sources of liquidity to cover liabilities, and this potential source of risk is a possibility that a bank regulator would want to explore while examining Generic Bank.

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

Per ASC 326-30-35-4, impairment of securities must be addressed at the level of individual securities. It follows that, regardless of whether the Generic Bank securities portfolio, as a whole, is in a net gain position, the individual securities within the portfolio must be examined to determine potential impairment.

Regarding my assessment of the seven securities listed in requirement 1, my conclusion is still be that the securities designated 003, 015, 025, 030, and 076 are impaired, as their fair value has declined below the amortized cost. This conclusion stands, regardless of if the portfolio is in a net gain position. In the hypothetical situation where all of the securities sold are in a net gain position, then no security impairment exists, as the securities do not meet the definition of impairment, as stated in ASC 326-30-35-1.

If the portfolio, or individual securities sold, or both, are in net gain positions, it does not impact my conclusion in Requirement 2. My conclusion that Generic Bank does not have impairment losses on any

securities, besides the seven sold in early 20x3, is based upon the guidance issued by FASB in ASU 2016-13 and the facts of the Case, which state that the decline in fair value of debt securities is due to fluctuations in interest rates and is not due to credit losses. Furthermore, Generic Bank has indicated that bonds will not be settled for less than full value, and that the Bank has the intent to hold these securities until maturity (Cantrell). Nothing in the financial statement has indicated that the bank lacks the ability to hold the bonds until they recover their value. It was based upon these facts, and not upon the net gain or loss positions of the seven securities sold, that I concluded that Generic Bank has no impairment upon the securities remaining in its portfolio.

Now assume that Generic Bank is adequately capitalized rather than well capitalized. And the bank desires to sell securities to improve capital ratios (through the reduction of risky assets) and to fulfill other borrowing obligations as they come due. Securities may not represent the only assets available to Generic Bank to sell, but access to other forms of borrowing to meet liquidity needs has become more limited.

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

In lowering Generic Bank's classification from "Well-Capitalized" to "Adequately Capitalized," the FDIC is indicating that, while Generic Bank's risk-based capital has increased, relative to total adjusted capital, it still possesses an adequate level of capital for the level of risk assumed. While this may be indicative of a larger trend, on the part of Generic Bank, towards an *inadequate* level of capitalization, at the present moment, I do not believe that it has a bearing on the debt securities held by Generic Bank. The causes behind the decrease in the total risk-based capital ratio will be of interest to third parties, such as external auditors and bank regulators, but as the FDIC classification designates, the bank is still adequately capitalized, if only for the present. Generic Bank's ability to hold the securities may change

may further deteriorate in the future, and, at such time, the bank's security holdings should be reassessed for potential impairment. However, all indications are present that the bank retains the ability to hold the securities and will, likely, not be forced to sell them at below amortized cost.

Given the established facts of the Case, which state that declines in fair value of debt securities are due to changes in interest rates and that the Generic Bank has the intent to hold the securities, coupled with my assessment that the Bank will likely retain the ability to hold the securities, I conclude that there is no impairment loss on the securities designated in Requirement #5.

Ian Ulmer

Case Study #5

City Case

November 7, 2018

I. Introduction

The purpose of Case Study #5: City Case is to conduct research into potential cities that students are considering for post-college employment. Many students have not lived in any of the cities, or even regions, that they are considering entering employment in, so the practical value of this case lies in the research that students will do on the cities that will be their homes for several years, at the minimum. Many students, I among them, have moved straight from hometowns into college towns, and do not have a concrete idea of where to move, post-graduation. This Case will impel each of us to examine what we desire in a city, pick out potential matches, research everything from climate to crime rates for each location, and, ultimately, confirm, refute, or modify our original opinions based upon the conclusions we reach in the course of our research. In this case study, I will be researching Raleigh, NC and Columbus, OH, cities that I chose based on my prior perceptions of the environment, affordability, and opportunity to be had in each city.

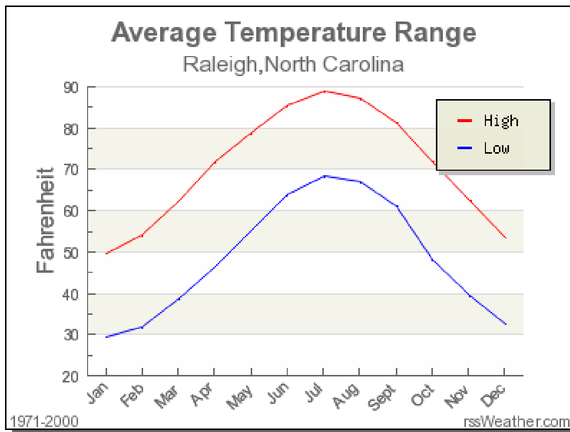
II. Raleigh, North Carolina

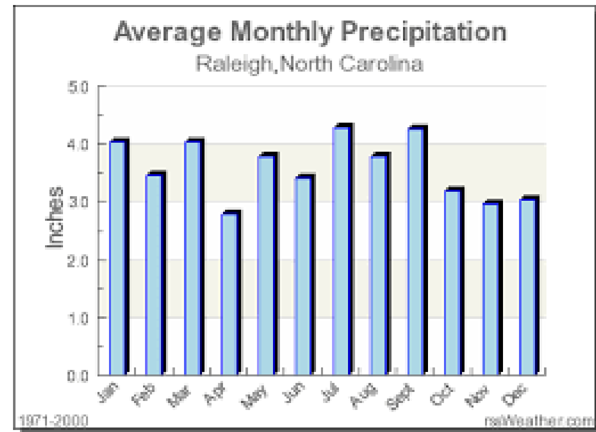
Having spent time in North Carolina several years ago, I was passingly familiar with the region, and have, largely, a positive impression of the area. Given the concentration of accounting firms within the region, I chose Raleigh as one of the prospective cities to research.

The metropolitan area surrounding Raleigh, NC is home to 1,786,119 people, with 464,758 living within the city proper, and is growing at an above average rate due to the influx of young professionals seeking positions in the growing job market. The stark population difference between Vicksburg, MS, with a population of 23,856, and the 1,786,119 strong population of Raleigh will certainly require a period of adjustment, but I don't anticipate having very much difficulty acclimating to life in a larger city. I am, on

the contrary, excited to explore the new opportunities and experience offered by life outside of small, Southern towns.

The climate is similar to that of Mississippi, with summer temperatures reaching 90 degrees, on average, and winter temps dipping into the lower 30's. However, rainfall in Raleigh falls over ten inches short of





Mississippi, annually, and snow is rare.

Professionals beginning their careers in Raleigh will benefit from fairly low tax rates. North Carolina is one of twenty states in the US to implement a flat tax of 5.75 percent, and the average sales tax rate in Wake County is 7.25 percent, and property tax, for those that own property, sits at 0.861 percent. For an individual making $50,000 a year, the total income tax burden, including federal taxes and only including the standard deduction, would total $7244. Assuming that a newly minted accountant will be renting, as opposed to buying a home in Raleigh, where the average home costs $227,814 in 2018, property taxes will not be incurred. However, given the 7.25 percent sales tax, a monthly budget for groceries, gas, and other necessities of $400 will yield an annual sales tax burden of $348. I am a saver by nature, and I appreciate that the taxes on residents of North Carolina is relatively low compared to other states, such as New York or California.

The most prevalent industries in North Carolina are Aerospace and Defense, Automotive Manufacturing, Biotechnology and Pharmaceuticals, Energy, and Information and Communications Technology. Several

of the largest companies headquartered in North Carolina include Wake Forrest Baptist Health, Duke Energy, Lowe's, BB&T, and Bank of America. The metropolitan area that exists between the cities of Raleigh, Durham, and Chapel Hill, NC, known as the Research Triangle, boasts one of the highest concentrations of physicians per capita due to the presence of two of the nation's top medical teaching hospitals at UNC Chapel Hill and Duke University. Within the Triangle, WakeMed, the UNC Healthcare System, and the Duke Medicine organization maintains and operates over half a dozen hospitals and thousands of beds for the residents of North Carolina. While I do not anticipate having to rely very heavily on the medical expertise that is available in the region, the unexpected is certain to occur at some point, and I'm sure that I will appreciate the quality of the medical care that can be found in Raleigh, should I find myself in need of it.

Crime in Raleigh is far lower than the national average, with just 228 violent crimes committed in 2016 per 100,000 people, versus 386 for the nation. Property crime beats the national average of 2450 per 100,000 people as well, with 1,862 committed in 2016. On the whole, the Raleigh metropolitan area is far safer to live in, statistically, than similar metropolitan areas. For example, nearby Charlotte, NC exceeds the national average in instances of violent and property crime by 441 and 2909 per 100,000 residents, respectively. General consensus of residents of the area is that, if Raleigh has one particular area that is higher in illegal activity, it would be the Mini City and Millbrook areas in the southeast area of the city; however, given the low crime rates, even these areas in Raleigh are not as statistically dangerous as other metropolitan areas. Coming from a town like Vicksburg, where crime is not very prevalent, the knowledge that Raleigh has a reputation as a safe city is a large factor in its favor when I weigh it as a potential city to move to in the near future.

When looking for potential housing in Raleigh, I had few absolute criteria. Optimally, the location would be relatively affordable, close to the offices of potential employers, and offer basic amenities such as air

conditioning, laundry units, and parking. The location that I decided upon is Shellbrook Apartments, located at 910 Shellbrook Court. Rent for a two-bedroom, two-bath apartment is $1,020 a month, which will be split with a roommate. Over three years, the total rent expense, to myself, would total $18,360, which I view as an acceptable trade in order to secure the convenience that Shellbrook Apartments offers.

The Lassiter 2-2 Model, the specific floor plan that I selected for this case study, is 1,071 square feet, complete with two full baths, a terrace, and in-unit laundry appliances. Shellbrook also accepts pets for a $300 up-front fee and $20 a month in rent, should that ever become a factor. Within a ten-minute drive are Kroger, CVS, Food Lion, and Dollar General locations, covering just about any general need that may arise. Perhaps the most important factor is the distance to the office, which is exceptional, at 6 minutes by car from the PwC Raleigh office, as well as numerous other businesses in the city center. All of these factors make Shellbrook extremely appealing to me as a renter. While cars are still the primary means of transportation, alternative means of transportation are gaining traction as the city invests more in public transportation infrastructure. Many parts of the city center are walkable, and for inner city travel, the R-LINE and Raleigh bus line provide public transportation, and the city has invested millions of dollars in biking infrastructure.

Raleigh is a cultural hub, and, as such, has events and activities to interest just about anyone. Preferring low cost, unstructured activities to fill my time, outside of work, I found many potential diversions to spend free time on in and around the city. William B. Umstead State Park is known for the quality of its walking and biking paths, both activities that I enjoy and fully intend to take advantage of, given to opportunity to live in the city. Another significant part of Raleigh's identity is the proximity of North Carolina State University, as well as the nearby Duke University and University of North Carolina at Chapel Hill. Given the concentration of world-class universities nearby, I expect to spend time attending

events and programs on the campuses. Among its many resident attractions are the abundance of art galleries and shops downtown, which, if nothing else, are free to look around in, while bargain-hunters will be attracted to the Raleigh Flea Market, a weekly open market that boasts over 600 vendors. I also enjoy music, and the number of entertainment venues in the city is astounding. Among the largest of the venues is the Red Hat Amphitheater, a 5000-seat outdoor music venue nestled in the heart of the city.

In addition to its diverse selection of entertainment options, Raleigh also boasts a large number of community organizations. The three organizations that I would choose to become involved with would be the SPCA of Wake County (Society for the Prevention of Cruelty to Animals), the Triangle Land Conservatory, and the Church of the Holy Cross. We have taken in stray animals, in my family, all my life, and I have spent countless hours on conservation projects as an Eagle Scout, so these organizations and I already share common interests.

Getting home, or really anywhere, from Raleigh is made simple by the close presence of the Raleigh-Durham International Airport, which offers flights to the Medgar Evers International for $265, outside of peak travel times.

Estimated Monthly Budget (Table 1):

Monthly Budget- Raleigh, North Carolina		
Pre-tax Income		$ 60,000.00
Annual Tax Expense		$ 9,949.00
After-tax Income		$ 50,051.00
Monthly Income		$ 4,171.00
Monthly Expenses:		
Rent	$ 510.00	
Utilities	$ 150.00	
Groceries	$ 150.00	
Gas	$ 80.00	
Insurance	$ 160.00	
Miscellaneous	$ 200.00	
Total:		$ 1,250.00
Surplus		$ 2,921.00

III. Columbus, Ohio

Columbus is similar to Raleigh in many ways, with a metro population of 1,995,004, which poses similar acclimation issues as Raleigh, as well as similar opportunities. The climate is also similar, with warm, humid summers, with temperatures moving between 66 and 85 degrees during the day, on average, and mild springs and falls. However, Columbus receives more snow, relative to North Carolina or Mississippi, getting an average of 27 inches, annually. The winters are also slightly colder than Raleigh, with the average high of 40 degrees and a low of 25 degrees during the winter months.

Housing in Columbus is even more affordable than Raleigh, with the average house costing just $171,075, over $50,000 less than the national average, and rent averaging $885 a month. These prices do increase, however, based upon location, as I found when searching for an apartment close to my potential office. The centrally located Bexley House complex is an appealing choice for housing, as it is just a five-minute drive to the offices of several accounting firms, including Deloitte and PwC.

Bexley House Apartments are pet friendly and have parking and in-unit laundry facilities for each unit; however, the rent is, correspondingly, more expensive, costing $1,394 a month for the Monterey Unit: a two-bed, two-bath apartment that covers 1,222 square feet (which would result in $25,092 in rent

expense to myself, over 3 years). As in Raleigh, sharing apartments with a roommate, or roommates, is an economically advantageous move, as a 1-bedroom apartment in the same complex would cost $1,040. Shopping for groceries, and other necessities, is made simple by the East Broad Street location of the Bexley Apartments. Within several minutes' drive is a Dollar General location, at 3000 East Broad Street, and two Kroger supermarkets, one located down the road at 3675 East Broad Street, and the other located south of Bexley House at 2000 East Main Street. There is also a CVS located at 3307 East Broad Street. While 90 percent of Columbus residents use a car for commuting, creating an average commute for the city of 23.5 minutes, the public transportation infrastructure in Columbus is more than adequate for servicing residents. The Columbus Ohio Transit Authority is the primary means of public transportation, running bus lines throughout the city limits, but there are a variety of other transit options as well, from taxi services to a bike sharing program that allows residents to rent use of a bike for traversing the city.

Overall, living in Columbus is statistically safer than living in many other metropolitan areas of similar size. The national average for violent crimes, per 100,000 people, was 386.3 crimes in 2016—during this same period, Columbus only recorded 290.3 such instances of violent crime, a figure 25 percent lower than the national average. Property crime in Columbus, however, is different. In 2016, instances of property crime in Columbus were 18.6 percent higher than the national average, with 2909.5 reported for every 100,000 people, versus the national average of 2450.7. While it is reassuring to know that Columbus beats the national average for violent crimes, it is slightly concerning that property crime is so much more prevalent in Columbus than in other areas, particularly when compared to Raleigh.

State income tax on $50,000 income will be $1,882, and federal income tax will be $7,244, assuming that the standard deduction is taken, creating a total income tax of $9,126 on $50,000 of income. Between the State and City Sales Taxes, the resident of Columbus can expect to pay sales tax of 7.5

percent, which, on a hypothetical monthly budget of $400 for items subject to sales tax, would result in $360 a year in sales tax paid to the state of Ohio and the city of Columbus.

If I were to move to Columbus, I would very likely engage in the same type of activities that I would in Raleigh. I have always enjoyed parks and forests, and Columbus has several of note. One such forest, Inniswood, covers over 100 acres of forest with hiking trails and paths, and, given its proximity to Columbus, it is very likely that I would spend significant free time there. Another activity to be easily taken advantage of, in Columbus, is the accessibility of biking as both exercise and leisure. The bike sharing program that I cited earlier as part of the city's public transit system can be easily applied to spending afternoons biking through the miles of trails that Inniswood and the numerous other parks have to offer. The Franklin Park Conservatory and Botanical Gardens, an 88-acre botanical collection in downtown Columbus, would also be on my list of locations to visit during my free time.

One of Columbus' most unique neighborhoods is the German Village, a historical enclave that grew out of the German immigrant neighborhoods of early Columbus. As a descendant of German immigrants, myself, I would enjoy the opportunity to explore traditional German culture in such a unique setting.

Much like Raleigh, Columbus also boasts several famous markets. Grocery shopping for foods to cook is one of my favorite activities in Oxford, and the North Market in Columbus would certainly afford me the opportunity to indulge this passion. Over a million people visit the Market, annually, which draws vendors from all over the state to come and sell their products. I am not a sports-and-clubs person, when it comes to entertainment, so it is important to me that the city that I choose to live in has ample opportunity to engage in things like farmer's markets and forest hikes, and it appears that Columbus has these opportunities in excess.

Community organizations are an excellent way to build ties with a new city, and I certainly intend to take maximum advantage of these opportunities. Like in Raleigh, I would focus on organizations that already

align with my interests, such as volunteering at the Columbus Humane Society, the Sierra Club, or the Crisis Hotline. I could possibly join one of the numerous churches in the city, like the Trinity Episcopal Church. I was a member of another Trinity Episcopal Church in Vicksburg, and I may feel the inclination to find a similar church when I've moved far from my hometown.

On a related note, travel back to my hometown will not be an issue in Columbus either, as it too has an international airport that makes frequent flights to Jackson, Mississippi. The prices are comparable to those that I priced for flights out of Raleigh-Durham International, as well, with a roundtrip flight being sold for only $270 for the off-peak season flight that I priced for. I recognize that I will be quite busy as a new employee in one of the accounting firms, but it's reassuring to know that trips back home will not be excessively difficult.

Estimated Monthly Budget (Table 2):

Monthly Budget- Columbus, Ohio		
Pre-tax Income		$ 60,000.00
Annual Tax Expense		$ 8,726.00
After-tax Income		$ 51,274.00
Monthly Income		$ 4,272.00
Monthly Expenses:		
Rent	$ 697.00	
Utilities	$ 150.00	
Groceries	$ 150.00	
Gas	$ 80.00	
Insurance	$ 160.00	
Miscellaneous	$ 200.00	
Total:		$ 1,437.00
Surplus		$ 2,835.00

IV. Conclusion

During the course of my research, many of the initial feelings that I had about the cities of Raleigh and Columbus were confirmed, and I found nothing that has significantly shifted my opinions on either city. I have no particular sentimental attachment to any city that I may have the opportunity to work in, so the

reasons that I chose to research the cities I chose was to verify that my initial impressions of the cities as relatively low cost areas with solid opportunities to find work and a milder climate than that of Mississippi was correct, and that, for the most part, is what my research led me to conclude. I feel that I would be content in either city; however, I do enjoy the ambiance of college towns, so if I were to pick one city over the other, I would choose to move to Raleigh. The industries that dominate the region are more varied, and the proximity of three nationally renowned research institutions is certain to bring more investment and opportunity into the region, in the future. I enjoy the climate of the Carolinas, the cost of living is low, and many businesses call Raleigh, Charlotte, and some of the smaller cites of North Carolina home, which in turn draws accounting firms to set up offices in those areas, providing great job opportunities for those in our field.

Ian Ulmer

Case Study #6

WorldCom, Inc.

November 16, 2018

I. Introduction

Along with Enron, the WorldCom scandal represents two of the most significant instances of fraud in the accounting profession. The purpose of this case is to examine the motives and means by which WorldCom executives manipulated the company's financial statements to meet external expectations and provide an economic boost to the company during a period of declining business for the company. Much of the case write-up will be given over to the specific details of the fraudulent practices of WorldCom, but consideration will also be given to the factors that gave rise to the possibility of the fraud, including an examination of the financial standards that were twisted and misinterpreted in order to provide a justification of the executives' actions as they related to the reporting standards set forth by FASB.

As accounting students, particularly students at Ole Miss, in Mississippi, where the WorldCom scandal had such a profound impact, this case holds a powerful cautionary tale for those entering our profession. It's said that the only way to avoid repeating the mistakes of the past is to study those mistakes, and the WorldCom case provides a look into the problems that can arise when financial information is subject to estimation and the opinions of those that handle the information. While there were several principles of GAAP that were violated over the course of the early 2000's at WorldCom, the factors that led to the misclassification and mis-capitalization of company expenses were the underlying ambiguity of some accounting standards that allowed for the judgement of executives to influence how costs were recorded. This case is important for students to study because it is a perfect example of how executives must carefully exercise judgement when making decisions, such as whether or not a cost should be capitalized or expensed, and must make every effort to faithfully represent the financial position of the company, with a reasonable degree of conservatism. Through this case, students learn about the various factors that can influence the reporting of financial information when the accounting

standards are not fully developed regarding a particular issue, and how large of an impact the misstatement of key financial information can have on a company's performance.

II. Concepts

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.

1. Explain how SCON 6 defines "asset" and "expense."

SCON 6 defines an "asset" as probable future economic benefits obtained or controlled by a particular entity as the result of past transactions or events. In other words, for an item to be accounted for as an asset, it must have the likely capacity to produce economic benefits for the controller in the future.

FASB gives a definition for expenses that is more strictly applicable to the events of the WorldCom case. FASB defines "expenses" as "as outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations." The key phrase in this passage is "ongoing major or central operations." For a company that, for example, manufactures widgets, all costs related to the manufacturing of said widgets would be an expense, as the manufacture of widgets is the central operation of the company. However, the costs of building a new factory to manufacture widgets would be accounted for as part of the cost of the asset, rather than an expense, because the costs associated with building a factory do not directly arise from the company's core operation: the manufacture of widgets.

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

Costs should be expensed when they are incurred as a result of ongoing operations, such as the manufacture of widgets. Costs should be capitalized as assets when they are incurred as result of

construction or development of an asset that would be classified as a long-term investment and bring economic benefits to the controller in the future.

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 costs are capitalized and included in the value of the asset, the costs hit the income statement through depreciation (or amortization) of the asset.

When a cost is capitalized, expenses are reduced on the income statement, because only a portion of the expense hits the income statement in a period, through recognition of depreciation/amortization, rather than all at once, as is the case if a cost is expensed. The asset section of the balance sheet is increased through the inclusion of the cost as part of the cost of the asset.

III. Process

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

Account	Dr.	Cr.
Line Cost Expense	**14,379,000,000**	
Cash		**14,379,000,000**

In 2001, WorldCom recorded Line Costs of $14.4 billion. In the business of telecommunications companies, line costs are the costs that telecommunications firms incur in order to obtain access to the telecommunications networks that are owned by third party telecom network providers. Line costs are

to be accounted for as an expense because telecom companies purchase access to the networks to provide their services to their customers. As the costs are incurred in the course of “rendering services,” they should be treated as an expense, per SCON 6.

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

According to the Wall Street Journal article, the primary cost that was improperly capitalized, at the direction of Mr. Sullivan, was the company’s line costs, costs incurred from paying local telephone networks to complete phone calls. During the late 1990’s and the beginning of the 2000’s, WorldCom purchased ever-increasing access to telecom networks, often through enormous, multi-year contracts. A decline in growth, however, left the company with too little demand to fill the capacity that they had purchased and, therefore, no revenue to cover the payments that WorldCom was contractually obligated to make to the third-party telecom network providers. Despite the fact that this network access was of a perishable nature, meaning that the excess could not be rolled over for future use, executives at WorldCom made the decision to account for line costs as if they were assets that could provide future benefits to the company, which they could not.

The line costs that WorldCom incurred from purchasing network access from third party providers were incurred for the purpose of providing the company’s service to its customers, a fact that directly and unequivocally identifies the cost as an expense, not an asset, under SCON 6.

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

Account	Dr.	Cr.
Property, Plant, and Equipment	**3,055,000,000**	
Cash (or Accts. Payable)		**3,055,000,000**

On the Balance Sheet, these costs will appear in the balance of the Property, Plant, and Equipment account, under the Asset section. On the Statement of Cash Flows, these costs will appear under the Investing section, as “Capital Expenditures” or some other such entry, appropriate for recording costs related to assets under the Investing section.

IV. Analysis

F. In a sworn statement to the Securities and Exchange Commission, WorldCom revealed details of the improperly capitalized amounts (in millions) in 2001: $771 in the first quarter, $610 in the second quarter, $743 in the third quarter, and $931 in the fourth quarter. Assume that WorldCom planned to depreciate these capitalized costs over the midpoint of the Useful Life (22 years) range for transmission equipment as disclosed in note 1. Further assume that depreciation begins in the quarter that assets are acquired (or costs capitalized). Calculate the related depreciation expense for 2001. Prepare the journal entry to record this depreciation.

Period	Amount	Annual Straight-Line Depreciation	Depreciation Period in 2001	Depreciation Applied in 2001
1st Quarter	$771,000,000	$35,045,455	(12/12)	$35,045,455
2nd Quarter	$610,000,000	$27,727,723	(9/12)	$20,795,792
3rd Quarter	$743,000,000	$33,772,727	(6/12)	$16,886,364
4th Quarter	$931,000,000	$42,318,182	(3/12)	$10,579,546
Total:	$3,055,000,000			$83,307,157

Account	Dr.	Cr.
Depreciation Expense	83,307,157	
Accumulated Dep.- PPE		83,307,157

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

WorldCom, Inc		
Stated Net Income, before Income Taxes		**$2,428,000,000**
Improperly Applied Depreciation Expense		**$83,307,157**
Less: Improperly Capitalized Expenditures		**($3,055,000,000)**
Corrected Net Income, before Income Taxes		**($543,692,843)**
Tax Effected Corrected Net Income (Loss)		**(353,400,348)**

In calculating the Corrected Net Income, the assumption is made that Minority Interests and Cumulative Effects of Accounting Changes do not change

The improper capitalization of $3.055 billion in line costs, in 2001, was certainly material for WorldCom, as this improper capitalization of costs allowed the company to record a net income of $1,5 billion, when the company would have incurred a net loss of $353.4 million in 2001, had the line costs been properly accounted for as expenses during the year.

Ian Ulmer

Case Study #7

Starbucks Corporation-Understanding

Financial Statements

March 9, 2019

I. Introduction

The purpose of this case is to examine the financial documents disclosed by a real-world entity, Starbucks, in order to gain an understanding of the intricacies of financial statements, outside of issues presented in accounting texts. The statements that will be examined include the most common financial documents, such as income statements and balance sheets, but also include disclosures that have profound impacts on entities in practice, but are rarely examined with scrutiny in academic texts, such as auditor opinions and footnote disclosures. In this case, examination and analysis of these financial statements will be required, with the goal of fostering an in-depth understanding of the function of financial statements and the wealth of information that can be extracted. In addition, while examining the structure of the financial statements of Starbucks, students will examine the role that estimation plays in the preparation of financial statements for publicly traded companies.

In this case, I learned how to access the available information about a public company through sources open to the public, such as the SEC's EDGAR database, and to transpose this information into a spreadsheet and construct common-size financial statements. I also learned how to use many of the most commonly issued financial statement, in concert, in order to make informed determinations about the financial state of a company, and to understand how the use of estimation impacts things like the revenue recognition principles and bad debt accounting of a large company like Starbucks.

II. Concepts

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

Through the operation of retail outlets, both company-operated and licensed to franchisees, Starbucks sells beverages, typically coffees and teas, with accompanying food items. Starbucks also sells prepackaged drinks and drink mixes to third-party retailers, such as Walmart or Costco.

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

The most common financial statements prepared for external reporting purposes are the Income Statement, Balance Sheet, Statement of Cash Flows, and Statement of Stockholders' Equity. In Starbucks' case, these documents are titled Consolidated Statement of Earnings, Consolidated Balance Sheets, Consolidated Statements of Cash Flows, and Consolidated Statements of Equity, respectively. In reference to Starbucks' financial statements, the term "consolidated" refers to the practice of displaying assets, liabilities, equity, revenues, and expenses of a parent company and its subsidiaries as a single economic entity.

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

Publicly traded companies typically prepare financial statements quarterly (designated 10-Qs), with one annual report (designated 10-K) containing all of the pertinent information relating to the entity disclosed in the previously released quarterly reports for the year. Any significant event impacting the company results in the issuance of a Form 8-K, regardless of timing.

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

The management of Starbucks is responsible for the preparation of financial statements, however, the chief executives are ultimately responsible, as well. Per the Sarbanes-Oxley Act, executives are required to sign off on financial statements and vouch for the material correctness of the documents.

Users of the financial statements are, in a broad overview, any individuals or entities that have, currently do so, or might potentially provide capital to the company, whether through the issuance of debt or the purchase of company stock. These users will examine the financial documents to ascertain the financial well-being of the company, assessing its ability to make payments on its debt, provide distributions to its shareholders, and continue to fund its ongoing operations. To this end, users may examine the company's current cash holdings, an indicator of ability to declared dividends or stock buybacks or to pay down debt levels, or may examine the level of long-term debt, relative to stockholder equity, in order to judge the company's financing structure. Topics that were relatively new were the examinations of audit opinion letters and the additional layer of complexity added to financial statement analysis by the inclusion of Starbucks' subsidiaries within the financial statements.

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

Starbuck's external auditors are Deloitte and Touche, LLP. In the first opinion letter to the Directors and Shareholders of Starbucks, Deloitte states that it has performed an audit of Starbucks' financial

statements for the year ended September 29, 2013, as well as those for the preceding two years, in accordance with the standards set by the PCAOB. In this letter, Deloitte informs that it has issued an unqualified opinion on the company's financial statements, indicating that the audit uncovered no material misstatements in the 2013 financial statements. The second opinion letter, also dated November 18, 2013, states that Deloitte has performed an audit of the company's internal control measures. It, too, ends with the issuance of an unqualified opinion, signifying that Starbucks maintained effective internal controls over financial reporting in all material aspects.

These reports are dated several months after the year-end owing to the fact that Starbucks must release financial statements before they can be audited and verified by external auditors, which is a process that takes a considerable amount of time.

III. Analysis

F. Use a spreadsheet to construct common-size income statements (which Starbucks calls statements of earnings) and balance sheets for 2013 and 2012. Common-size income statements scale each income statement line item by total net revenues (sales).

Consolidated Statements Of Earnings (USD $)	12 Months Ended				Common Size Income Statement	
In Millions	9/29/2013	9/30/2012	10/2/2011		9/29/2013	9/30/2012
Net revenues:						
Company-operated stores	$11,793.20	$10,534.50	$9,632.40		79.19%	79.21%
Licensed stores	1,360.50	1,210.30	1,007.50		9.14%	9.10%
CPG, foodservice and other	1,738.50	1,554.70	1,060.50		11.67%	11.69%
Total net revenues	14,892.20	13,299.50	11,700.40		100.00%	100.00%
Cost of sales	6,382.30	5,813.30	4,915.50		42.86%	43.71%
Store operating expenses	4,286.10	3,918.10	3,594.90		28.78%	29.46%
Other operating expenses	457.2	429.9	392.8		3.07%	3.23%
Depreciation and amortization expenses	621.4	550.3	523.3		4.17%	4.14%
General and Admin expenses	937.9	801.2	749.3		6.30%	6.02%
Litigation charge	2,784.10	0	0		18.70%	0.00%
Total operating expenses	15,469	11,512.80	10,175.80		103.87%	86.57%
Gain on sale of properties	0	0	30.2		0.00%	0.00%
Income from equity	251.4	210.7	173.7		1.69%	1.58%
Operating income	-325.4	1,997.40	1,728.50		-2.19%	15.02%
Interest income and other, net	123.6	94.4	115.9		0.83%	0.71%
Interest expense	-28.1	-32.7	-33.3		-0.19%	-0.25%
Earnings before income taxes	-229.9	2,059.10	1,811.10		-1.54%	15.48%
Income taxes	-238.7	674.4	563.1		-1.60%	5.07%
Net earnings including noncontrolling interests	8.8	1,384.70	1,248		0.06%	10.41%
Net earnings attributable to noncontrolling interest	0.5	0.9	2.3		0.00%	0.01%
Net earnings attributable to Starbucks	$8.30	$1,383.80	$1,245.70		0.06%	10.40%

Table 7.1: Starbucks' Common Size Income Statement

Consolidated Balance Sheets (USD $)	Balance Sheet			Common Size B/S	
In Millions	9/29/13	9/30/12		9/29/13	9/30/12
Current assets:	'				
Cash and cash equivalents	$2,575.70	$1,188.60		22.36%	14.46%
Short-term investments	658.1	848.4		5.71%	10.32%
Accounts receivable, net	561.4	485.9		4.87%	5.91%
Inventories	1,111.20	1,241.50		9.65%	15.10%
Prepaid expenses/ Other CA	287.7	196.5		2.50%	2.39%
Deferred income taxes, net	277.3	238.7		2.41%	2.90%
Total current assets	5,471.40	4,199.60		47.51%	51.09%
Long-term investments	58.3	116		0.51%	1.41%
Equity and cost investments	496.5	459.9		4.31%	5.60%
PPE, net	3,200.50	2,658.90		27.79%	32.35%
Deferred income taxes, net	967	97.3		8.40%	1.18%
Other assets	185.3	144.7		1.61%	1.76%
Other intangible assets	274.8	143.7		2.39%	1.75%
Goodwill	862.9	399.1		7.49%	4.86%
TOTAL ASSETS	11,516.70	8,219.20		100.00%	100.00%
Current liabilities:	'	'			
Accounts payable	491.7	398.1		4.27%	4.84%
Accrued litigation charge	2,784.10	0		24.17%	0.00%
Accrued liabilities	1,269.30	1,133.80		11.02%	13.79%
Insurance reserves	178.5	167.7		1.55%	2.04%
Deferred revenue	653.7	510.2		5.68%	6.21%
Total current liabilities	5,377.30	2,209.80		46.69%	26.89%
Long-term debt	1,299.40	549.6		11.28%	6.69%
Other long-term liabilities	357.7	345.3		3.11%	4.20%
Total liabilities	7,034.40	3,104.70		61.08%	37.77%
Shareholders' equity:					
Common stock ($0.001 par) -1,200 authorized; 749.3 outstanding	0.8	0.7		0.01%	0.01%
Additional paid-in capital	282.1	39.4		2.45%	0.48%
Retained earnings	4,130.30	5,046.20		35.86%	61.40%
Accumulated Other Comp. Income	67	22.7		0.58%	0.28%
Total shareholders' equity	4,480.20	5,109		38.90%	62.16%
Noncontrolling interests	2.1	5.5		0.02%	0.07%
Total equity	4,482.30	5,114.50		38.92%	62.23%
TOTAL LIABILITIES AND EQUITY	$11,516.70	$8,219.20		100.00%	100.00%

Table 7.2: Starbucks' Common Size Balance Sheet

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

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

2013 Balance Sheet (in millions): $11,516.7 (Assets) = $7,034.4 (Liabilities) + $4,482.3 (Equity)

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

Starbucks' major asset classes consist of its Current Assets (Cash, Short-term Investments, Receivables, Inventory, and Prepaid Assets), Property, Plant, and Equipment, and its Intangible Assets. The ratio of Current Assets to Noncurrent Assets is 0.91, which seems appropriate for a beverage retailer that operates primarily out of company-owned locations.

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

In general, Intangible Assets are non-physical assets that will be consumed over more than one accounting period. Examples of intangible assets are copyrights, patents, and goodwill. Goodwill is the excess of the purchase price paid for an acquired entity and the among of the price not assigned to acquired assets and liabilities; it is only generated from an acquisition—it cannot be generated internally. Specific intangible assets that may be owned by Starbucks likely include copyrights over company symbols, such as the Starbucks logo or name, and patents concerning parts of the coffee roasting or preparing process that Starbucks developed and maintains ownership over.

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

Starbucks is financed through a combination of debt and owner equity, through the issuance of stock to the public. The proportion of total financing that comes from non-owner sources can be calculated using the Debt-to-Asset Ratio, which is calculated as Total Debt divided by Total Assets. The calculation is as follows:

Debt/Asset Ratio = 7034.4/11,516.7 = 61.08 percent

This indicates that 61.08 percent of Starbucks' total financing comes from non-owner sources.

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

i. Review the revenue recognition policies of Starbucks discussed in Note 1 (Summary of Significant Accounting Policies). Does Starbucks record revenue when they receive cash from their customers (cash-basis accounting) or do they follow a different rubric (for example, accrual accounting)? How does Starbucks record revenue on stored value cards (i.e., gift cards)? What challenges in measuring revenue do you observe? That is, are there any significant judgments management needs to make in recording sales revenues at Starbucks?

When accounting for Company-Owned Store Revenues, Licensed Store Revenues, and Foodservice and Other Revenues, Starbucks recognizes revenue at the moment the obligation is satisfied. In the case of revenue generated through company owned stores, revenue is recognized when payment is tendered at the point of sale. In the case of licensed stores and revenue generated by sales to third party vendors, revenue is recognized when products are shipped or services, such as new company training, are performed by Starbucks. According to its disclosure regarding Revenue Recognition Principles, Starbucks

recognizes revenue from stored value cards when the cards are redeemed, or the likelihood of redemption is deemed to be remote. The estimation of whether or not stored value cards are unlikely to be redeemed is likely a challenge that requires judgment on the part of management. Another issue that could arise could be making estimations for the percentage of Accounts Receivable that will become uncollectable during a period.

ii. What are Starbucks' major expenses?

Starbucks' major expenses are Cost of Goods Sold and Store Operating Expenses, including Labor Costs, which works out logically as the majority of Starbucks' business is contingent upon selling its product inventory through its company operated stores.

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

The most significant change in the Expenses portion of Starbucks' Consolidated Statement of Earnings from 2012 to 2013 is the Litigation Charge reported in the year ended September 29, 2013, in the amount of $2.784 billion

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

General and Administrative Expenses are defined as the set of expenses required to administer a business and generally described the fixed cost structure of the business. G&A Expenses can include legal expenses, but are limited to the wages paid to legal staff, not other legal expenses, such as the expense incurred as the result of the loss of a lawsuit, which is the source of the $2,784,100,000 litigation expense recorded by Starbucks. Also, the litigation expense is, roughly, three times the amount of G&A Expenses recorded by Starbucks for the year ended September 29, 2013, which would drastically

alter the balance of the G&A Expense account and materially misrepresent the fixed costs of the company, as the litigation expense is a one-time expenditure. The charge is still included in Operating Expenses because legal fees are included in Operating Expenses on the Income Statement.

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

In 2012, Starbucks was profitable by all metrics. In 2013, Starbucks reported an Operating Loss of $325,400,000, attributable to the Litigation Expense. However, as a result of this Operating Loss, Starbucks received a significant tax break, resulting in a Net Income of $8,800,000 for the year ended September 29, 2013. Since Net Income is the "bottom-line" by which a company is typically judged, Starbucks was profitable in 2013.

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

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

In fiscal 2013, Starbucks posted Net Earnings of $8,800,000, while Cash Provided by Operating Activities was $2,908,300,000. The difference between these two line items is primarily explained by the Litigation Expense recorded by Starbucks in fiscal 2013, which has to be added back to Net Earnings in order to determine the Cash Provided by Operating Activities, as well as the differences due to Depreciation and Amortization Expense, which affect Earnings but do not impact the company's Cash balance.

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

In fiscal 2013, Starbucks spent $1,151,200,000 on expenditures for Property, Plant, and Equipment.

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

In fiscal 2013, Starbucks paid Cash Dividends, in the amount of $628,900,000, per the information contained in the Financing Activities sub-section of the Consolidated Statement of Cash Flows. However, during 2013, Starbucks declared Cash Dividends of $668,600,000, as stated in the Consolidated Statements of Equity. This results in a credit balance of $39,700,000 in Starbucks' Dividends Payable account.

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

In the Notes to Consolidated Financial Statements, sub-section titled "Estimates and Assumptions," Starbucks' policies regarding estimation, when preparing financial statements, are disclosed. Starbucks makes estimates concerning impairment of assets and goodwill, stock-based compensation forfeiture rates, future asset retirement obligations, inventory reserves, allowance for doubtful accounts, and depreciation and amortization. This is not an exhaustive list, but rather lists the major balance sheet accounts that are impacted by the use of estimates.

Ian Ulmer

Case #8

BP p.l.c – Contingencies

April 2, 2019

I. Introduction

The Gulf Oil Spill was one of the most significant economic events to impact the Gulf Coast in the 21st century, and the number of individuals and businesses affected, either directly or indirectly, by the disaster is difficult to quantify. On April 20, 2010, the BP-operated Deepwater Horizon oil rig suffered an explosion and catastrophic collapse, killing 11 workers and spilling over 200 million gallons of oil into the Gulf, resulting in a months-long clean-up process that cost business and individuals billions in lost earnings and damages. Having grown up in Mississippi, one the states most affected by the accident, the BP oil spill is an extremely relevant chapter in the economic history of my home, similar to the WorldCom scandal, and the lessons that can be taken away from such a tragedy are worth studying, not simply for the complex accounting case that it presents, but for the wider implications about business processes and corporate responsibility, as well.

As the long-term effects of the spill are becoming more apparent, the financial implications of such a disaster are complex and difficult to estimate. The primary objective of this case is for students to understand the accounting implications of contingent liabilities, and the role that estimation plays in such accounting determinations. In addition, students will compare the characteristics of contingent liabilities that concern unforeseeable disasters, such as the Deepwater Horizon event, and contrast these against the accounting for more routine contingent liabilities, such as warranty liabilities or the estimations made for sales returns of company goods.

In the process of completing this case, I became much more aware of the inexact nature of accounting for contingent liabilities, as applied to real-world business examples. Theoretical examples of contingent liability accounting are typically straightforward and focus more on the determination of the existence of the liability, or pertain to more common examples, such as warranty liability, whereas the BP oil spill presents a unique set of circumstances to be analyzed. Much of the complexity of working the case

arises from the unpredictable nature of the economic costs of the event, which will not become fully apparent for years to come, and the sheer size of the disaster. The scope of the Gulf Oil Spill gave it the capacity to affect an entire region and impact just about every major industry in some way. The study of this event is an excellent opportunity to analyze the difficulties that can be encountered when attempting to quantify a company's liability in any given situation.

II. Concepts

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

A contingent liability is defined as an obligation that is dependent upon the occurrence or nonoccurrence of one or more future events to confirm either the amount payable, the payee, the date payable, or its existence. Contingent liabilities are classified as either probable, reasonably possible, or remote.

A company records a contingent liability on its books when the following conditions are met: the liability is likely to occur (probable) and can be reasonably estimated. These conditions are heavily judgement-based and are typically based on prior experience and the judgement of accounting and legal experts, so there is a degree of estimation involved, but if the benchmark standard is met, the company records the liability, in accordance with GAAP.

The most common types of contingent liabilities consist of, but are not limited to, liabilities resulting from unfavorable rulings in litigation, warranties issued for a company's product, or liabilities that may arise as a consequence of a company signing as guarantor of a loan, on behalf on another party.

In accordance with GAAP, companies adopt a conservative approach to accounting for contingent gains. Contingent gains are never recorded on a company's books, and they are only disclosed in the footnotes to financial statements when the gains are judged to have a high probability of occurring.

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

From BP's perspective, as the buyer of the product, the product warranty is the guarantee that the product will be replaced if it does not function as intended, for a pre-determined period of time, in this case two years. As such, this could be a contingent gain, contingent on the future event of the machine breaking down, within the warranty period. As a contingent gain, the amount associated with the product warranty would never be recorded on BP's books.

From GE's perspective, the product warranty on the telescopic joint is a contingent liability that will be realized in the event that the product fails to function as guaranteed. GE will record an estimated warranty liability related to the sale of its products during the fiscal year, including the telescopic joint sold to BP. This liability will often be based on a calculation made by GE that assumes that a certain percentage of the products will have to be replaced under the warranty.

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

In accounting for contingent liabilities, two of the most significant judgements that management must make concern the likelihood of the liability occurring, and the value of the liability. Given the uncertainty of interpretation regarding the definitions of "probable," "reasonably possible," and "remote," as they apply to the existence of contingent liabilities, management must exercise significant judgement when labeling liabilities, dependent as they are upon often vague or excessively complex legal jargon.

In the particular case of the accrual of liabilities, management will encounter the same issues with the classification of liabilities, as described above, given that a liability is accrued when it is probable, but managers must also make estimates as to the dollar amount associated with the liability in order to properly document the accrual. For some accruals, such as the collectability of receivables or the obligations related to warranties on products sold, the company has policies in place that specify the amount to be accrued as a liability. A good example is the retailing company that estimates that 2 percent of accounts receivable for the period will be uncollectable, and records that resulting accrued liability, which will be adjusted upon the realization of the liability.

Warranty claims may involve less uncertainty in the calculation of the contingent liability for a company, as the company likely has extensive analysis of past periods to support the prediction of future warranty obligations. For a rarer, and more unpredictable event, such as the Deepwater Horizon oil spill, the calculation of the potential liability will be much more complex. The calculation will depend on the severity of the event, which may not be fully known for an extended period of time, the degree to which the company is deemed responsible for the event, or the myriad other circumstances surrounding the

event. In the case of the Deepwater Horizon spill, the company recorded liabilities that would result directly from the operations of the parties involved to contain and repair the damage that resulted from the oil spill, as well as the fines leveled against the company by governmental entities. These are liabilities that involved less predictive uncertainty, as the costs of repairing the damage of the spill, in the immediate aftermath, were able to be reasonably accounted for, and the fines that would be levied could be predicated based on the statues set forth by the government. The greatest uncertainty results from the contingent liabilities that could result from the civil litigation against the company, which could come from any number of claimants with varying degrees of valid injury and could be fought in court for years into the future; however, these civil cases would most likely hinge upon a plaintiff's ability to prove gross negligence on BP's part. To prove gross negligence, it would have to be proven that the defendant blatantly disregarded a duty of care or intended to cause injury to the plaintiff.

D. Describe some of the estimates that BP must make to account for the contingencies associated with the Deepwater Horizon oil spill. By way of comparison, the Exxon Valdez oil spill took place on March 24, 1989. Litigation continues as of early 2011. Also, prepare a list of potential parties that may file lawsuits against BP that may be prepared by an external auditor conducting analysis of the company's accounting for contingent liabilities.

In accounting for the contingencies associated with the Deepwater Horizon spill, must make estimates concerning future obligations to any further expenses related to the clean-up of the oil spill and to pay any further fines that may be imposed by various regulatory agencies, but the largest contingent obligation that BP must estimate will be the compensation to parties injured, physically and financially, as a result of the Deepwater Horizon event, as well as the associated legal fees that will undoubtedly accompany the years of litigation to come. To cover such obligations, at the time of composition of this case, BP has set aside $20 billion in a fund to pay out future compensations.

The number of aggrieved parties impacted by the oil spill reflects the widespread fallout of the disaster, and the responsibility of estimating the number of potential claimants for compensation will rest with management; however, it would be prudent for BP's external auditors, EY, at the time of the spill, to prepare a list of parties that could, potentially, file lawsuits against the company for compensation for lost business, as a result of the oil spill. The most directly affected parties would be those parties whose revenue is derived from the Gulf of Mexico, whether they be workers on the Deepwater Horizon that were killed or lost their jobs, operators of other rigs whose operations were suspended in the aftermath of the disaster, commercial fishermen, guides for deep sea fishing trips, or cruise line operators that sail through the Gulf. These parties will be directly impacted by the oil spill, as it will make their core operations untenable for the period of the spill cleanup.

The list of businesses that could potentially suffer as a secondhand result of the oil spill is much longer and more complex to account for, spanning numerous industries in ways that may not be immediately recognizable to BP. Given the prominent nature of the tourism industry in the Gulf, it can be reasonably expected that related industries will suffer, such as the hospitality industry or the portion of the restaurant industry whose businesses are located on the coast and base much of their continuing operations on supplies that come from the Gulf. The transportation industry may suffer financially as well, given that revenue will certainly be lost due to the decrease in travelers to the region. The loss of tourists to the coast will likely have an impact on industries that deal in non-essential goods and services. The entertainment and luxury goods industries will likely lose revenue, as a substantial portion of their sales are likely related to the number of tourists that patronize their businesses. It is also documented that real estate values dropped on the Gulf Coast in the period following the spill, affecting real estate businesses and private homeowners, alike.

Perhaps the most significant threat to BP, as far as potential litigation is concerned, is the number of individuals who may file lawsuits against the company alleging that they suffered medical harm as a result of the spill, whether through exposure to the oil itself, or the variety of chemicals that were used to clean up the spill. These claims have the potential to be far more numerous and costly than the fines, clean-up expenses, and litigation faced by the company, to date.

Ian Ulmer

Case #9

The Wendy's Company – Equity Method Investments

April 10, 2019

I. Introduction

The objective of this case is to introduce students to the concept of joint ventures through the real-life case of Wendy's Company, the American fast food chain, and its partnership with Tim Hortons Inc, the Canadian restaurant chain, to invest in a joint venture that would operate combination Wendy's/Tim Hortons restaurants in Canada. Students will research and document the basic concepts of joint ventures and their strategic purposes, to lay the groundwork for the accounting theory that will be studied in Parts III and IV. Students will be introduced to the various means of accounting for investments, and particular emphasis will be placed on the equity method of accounting for investments. An understanding of how the equity method is implemented will be key to analyzing the financial statements of TimWen, the investee, and how the various components of TimWen's financials impact the financials of Wendy's, the investor. Finally, students will examine the alternative means of accounting for investments that could possibly be applied to the investment and explore how these alternatives could impact the financial statements of the investor.

Intermediate Accounting covers accounting for investments in depth, so I was familiar with the principles of the equity method for accounting for investments, but the context of the investment as a joint venture wholly owned and operated by two investors added a novel element to the case study. Joint ventures, as a business entity, were an unfamiliar concept beyond surface level conceptual knowledge, so much of the learning that I took away from this case concerned the structure of joint-ventures and the accounting issues that relate to them. Examining how equity investments are accounted for in a real-world business entity was interesting, particularly the ways in which equity investments are included in financial statements—the most striking example of which is Wendy's inclusion of earnings from equity investments under the line item "Other Operating Expenses, net," as opposed to an item similar to an investment income account, like I would have expected. Exposure to

the intricacies of financial accounting, beyond the classroom, has provided me with valuable perspective going forward.

II. Concepts

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

Companies may enter into joint ventures with other companies for a variety of reasons; however, the primary goal of any joint venture is to grow both businesses in some way. The objective for the venture may be to increase market share, expand into new markets, or to make business operations more efficient through the sharing of technical knowledge, process improvements, or warehousing and distribution networks.

B. Consistent with U.S. GAAP, Wendy's uses the equity method to account for its joint venture in TimWen. Briefly explain this accounting method. In your answer, be sure to comment on how the investing company accounts for its initial investment and any subsequent income and dividend activity of its investee.

The equity method of accounting is used when an investor owns 20 to 50 percent of the investee. In accounting for the initial investment, the investor (Wendy's) will record a debit to Equity Investments and a credit to Cash for the amount of the investment. Subsequently, when recording income activity of the investee (TimWen), Wendy's will debit Equity Investments and credit Income from Investments for the amount of TimWen's income proportionate to Wendy's ownership interest. If TimWen sustains a net loss for the year, Wendy's will debit Loss on Equity Investment and credit the Equity Investment account to record the loss. When accounting for dividend distributions from the investee, Wendy's will debit Cash equal to the dividends that are received while crediting the Equity Investment account, as dividends are accounted for as a reduction of shareholder equity under the Equity Method.

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

When a company acquires an investment for a price that is greater than the book value of the proportion of assets that the investor owns, the excess of the purchase price over book value is first assigned to any subsidiary assets and liabilities whose fair value exceeds book value, if possible. Otherwise, the excess is debited to the asset account "Goodwill." Note that goodwill can only be created at the instance of acquisition, not subsequent to the acquisition.

III. Process

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

At the end of 2011, Wendy's recorded their equity investments at the amount of $91.819 million. At the end of 2012, equity investments were recorded at a value of $87.62 million. Wendy's equity investments appear on the consolidated balance sheet under the non-current asset "Investments."

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

From the balance sheet information for TimWen, Partner Equity is record as $70.565 million at December 30, 2012, of which, Wendy's has a claim to 50 percent, or $35.283 million. On Wendy's balance sheet, however, the equity investment in TimWen is recorded at a valuation of $89.37 million, which represents an excess of $54.088 million over equity interest. In the Notes to Consolidated

Financial Statements, Wendy's states that this excess is due, primarily, to the excess paid by Wendy's for its share of the Tim Horton's equity investment, labeled the Acquisition Accounting Premium.

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

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

In 2011, Wendy's 50 percent investment in TimWen contributed $13.505 million in earnings to Wendy's in Income from Investments; in 2012, Wendy's Income from Investments (via TimWen) was $13,680,000. In Wendy's Consolidated Statement of Operations, this income appears under the "Other Operating Expenses, net" line item.

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

Equity Investments	13,680,000.00	
Equity Income		13,680,000.00

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

Equity Income	3,129,000.00	
Equity Investments		3,129,000.00

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

12/31/2011	Cash	14,942,000.00	
	Equity Investments		14,942,000.00
12/31/2012	Cash	15,274,000.00	
	Equity Investments		15,274,000.00

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

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

Equity Investments		
Tim Horton's:		
Equity in Earnings for the Period	$13,680,000.00	
Amortization of Purchase Price Adjustments	($3,129,000.00)	$10,551,000.00
Japan Joint Venture:		
Equity in Losses for the Period		($1,827,000.00)
Equity in Earnings from Equity Investments		$8,274,000.00

When reconciling Net Income to Net Cash from Operating Expenses, Wendy's is required to deduct Equity in Earnings for the Period from Net Income. The recording of Equity Earnings involves a credit to Equity Income, which runs through Net Income, necessitating the deduction of the Equity in Earnings to arrive at Net Cash from Operating Activities.

ii. The operating section also reports a positive adjustment for "Distributions received from joint venture" of $15,274 in 2012. Explain why a positive adjustment is made to arrive at net cash from operating activities.

The positive adjustment of $15,274 (in thousands) is a result of the dividend distributions that Wendy's receives from TimWen in 2012. This is a positive adjustment because it's not included in net income, rather it's treated as a reduction of the equity investment. However, it is cash that is entering Wendy's balance sheet, so it must be added back to Net Income to arrive at Net Cash from Operating Activities.

Ian Ulmer

Case #10

Johnson & Johnson – Retirement Obligations

April 19, 2019

I. Introduction

The purpose of the Johnson & Johnson case is to perform an in-depth examination of the company's financial records regarding their pension fund and the process by which the company arrives at different valuations for the various components of their pension activities. Most of the detailed information regarding a company's pension obligations is not contained within the financial statements, rather, much of this detailed information is contained within the footnote disclosures to the financial statements, which students will learn to locate, analyze, and synthesize into insights about the company's financial position. Additionally, students will examine the complications of pension obligation analysis that arise from the discrepancies in funding pension funds and the related expensing that occurs. Lastly, students will examine the various line items that make up pension assets, liabilities, and expenses, and how each of these items are impacted by the assumptions that must be made in order to properly account for a company's retirement obligations.

Financial Accounting II does an excellent job of explaining the basics of pensions and the process by which a company accounts for them, but, in every example, the information required to compute pension expense, for example, is explicitly stated in the problem. Prior to working this case, I had no experience in sifting through a company's footnote disclosures in order to find the individual components of the pension obligation, and I feel that this is valuable experience to have going forward, as examination of pension obligations is a common assignment in public accounting, and the information of an actual company will be presented in the same format as this case.

II. Concepts

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

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

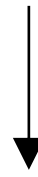
Defined benefit plans are employer sponsored pension plans that are structured to pay out a fixed amount to pensioners each month and are based on the length of an employee's tenure at a company and their salary during the last several years of employment. Under the defined benefit plan, employers must make the necessary monthly contribution to the retirement plan in order to pay out the fixed amount to their pensioners upon retirement.

Defined contribution plans are the structural inverse of defined benefit plans. While the benefits are known, under the defined benefit plan, and employers must make whatever contribution necessary to reach that benchmark; in the case of defined contribution plans, the ultimate amount that will be paid out to a pensioner upon retirement is not known. Instead, the company makes a fixed contribution each month, and the retirement benefit paid out each month will be based on the amount currently invested in the account upon retirement of the employee. Johnson & Johnson sponsors both types of plans.

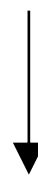
ii. Explain why retirement plan obligations are liabilities.

Retirement plan obligations are accounted for as liabilities because they meet all three of the criteria of liabilities: they represent probable future sacrifices of economic benefits arising from present obligations (the retirement obligation), they require an entity to transfer assets or provide services to other entities in the future (the payment of promised benefits), and they are a result of past transactions or services (the beneficiary's service to the company). The process of incurring a pension obligation is summarized in the following chart:

The beneficiary provides service to the employer.

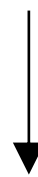


The employer computes the increase in Projected Benefit Obligation resulting from service costs, interest costs incurred on the beginning balance of the PBO, and amortization of Prior Service Costs.



The employer contributes to the pension fund, overseen by a third-party management entity, resulting in a debit to the Plan Assets account and a credit to Cash. In the event that the contributions to the fund and the actual return on the plan assets do not fund the plan to a sufficient level to meet the employer's obligations, or excessively fund the plan, the employer records a credit, or debit, respectively, to Pension Assets/Liability, representing the over-funded or under-funded status of the plan.

If changes are made to the actuarial assumptions that are used to compute portions of the employer's obligations, such as the projected lifespan of the employee, the future salary of the employee, or the discount rate used to calculate the PBO, the employer makes an entry to adjust the PBO, crediting the account if the change results in an increased obligation, and debiting the account if the change reduces the obligation. In both cases, the employer will also make a balancing entry to Other Comprehensive Income (Gain/Loss).



When the beneficiary elects to begin receiving their benefits, the management company pays the benefits out to the beneficiary. This has the effect of reducing both the PBO and the Plan Assets on the employer's books.

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

When accounting for retirement plan obligations, employers must account for a variety of factors, and estimations play an important role in making determinations related to the obligations. Several of the most significant assumptions that the company must make relate to rates of return and increasing rates of payout. Given that employer contributions alone may not be sufficient to cover the payouts to pensioners, in the future, pension funds are invested to generate greater returns. In order to account for the value of these plans, employers must make estimations regarding the rate of return that the investments are expected to return. Another significant assumption that must be made is the increase in the payouts required each year, in order to keep up with factors such as inflation. Given the long term nature of pension payouts, the dollar amount of the first payment made will not equate to the same purchasing power as the same dollar amount of the payment made twenty years into retirement, for example, so employers must plan for increases in the payment amount, which makes estimating a rate of increase necessary. Estimations must also be made regarding more difficult calculations made for the projected life span of employees and their ending salaries that will affect the benefits they will receive.

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

With regards to pension obligations, service costs refer to the addition pension liability incurred by the services performed by company employees during the year. Given that many pension plans depend on the length of service of the employee, as a year passes and service is performed, the obligation of the employer increases. Interests costs are closely related, as they arise from the passage of time, which increases the obligation liability to the company.

Given the need to create estimations for the amount of pension payments to be made in a given year, there naturally exists a discrepancy between the amount of pension payments expected and payments made. When such a discrepancy exists, an adjustment must be made to record the gain, if actual payments are less than expected, or to record the loss, if actual payments exceed expected payments.

The asset retirement obligation exists because of the future payments due to employees. Therefore, when payments are actually made to employees, the obligation decreases. In the context of pension obligations, payments to retirees reduces the company's liability.

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

The primary funding for a company's pension fund comes from contributions made by the company on the employee's behalf, whether defined as a set amount or not. When the company makes contributions to the retirement fund, those funds are not left idle; rather, they are invested in assets designed to generate a positive return. The rate of return earned on these investments determines much of the value of the retirement fund, and therefore is an important influence on the pension's asset valuation. Lastly, the benefits paid to retirees has a significant impact on the assets held by the pension fund. When payments are made to retirees, the payments deplete the assets of the fund in order to make the payments.

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

In computing pension expense for the year, a company is making a projection regarding the expense for the coming year, meaning that several factors, such as Return on Plan Assets, must be estimated, as a

return for the year has not yet been realized. At year end, once the actual return generated by plan assets is known, this return is recorded as an increase to Plan Assets. If the Actual Return on Plan Assets differs from the Expected Return on Plan Assets, an entry must be made in order to reconcile the accounts—the account used to record unexpected asset gains and losses is Other Comprehensive Income (Gain/Loss). In the event that Actual Return is lower than Expected Return, the company makes a year-end entry that records a debit to OCI (G/L), which has the effect of raising Pension Expense as a result of the lower return. Inversely, the company credits the OCI (G/L) account in the event that Actual Return on Plan Assets exceeds Expected Return on Plan Assets.

III. Process

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

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

Johnson & Johnson reported pension expense of $646 million in 2007.

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

Pension Expense	597,000,000	
Pension Benefit Obligation		597,000,000
Pension Expense	656,000,000	
Pension Benefit Obligation		656,000,000

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

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

Johnson & Johnson's retirement plan obligation at the end of 2007 is $12,002 million. This value represents the change in value of the retirement plan obligation from January 1, 2007 to December 31, 2007. This number is to be considered reliable because it is the documentation of the change in value of the obligation from all sources.

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

Johnson & Johnson's average interest rate is computed as follows:

Interest Expense/Beginning Obligation = 656 million/11,674 million = 5.62 percent

Johnson & Johnson's computed average interest rate seems reasonable. The discount rate used by Johnson & Johnson for the U.S. benefit plan is 6.5 percent, and the rate used for the international plan is 5.5 percent. The company's average interest rate would logically be between these two values, depending on the number of plans with different interest rates, relative to the total number of plans, and it appears that the rate computed falls between the upper and lower rates established for the company's different benefit plans.

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

Benefits paid to beneficiaries totaled $481 million in 2007. It is assumed that the Johnson & Johnson pension fund uses plan assets to extinguish these obligations. The benefits paid out to retirees decrease both the retirement plan obligation and the retirement plan assets, since Johnson & Johnson uses the assets in the fund to satisfy the retirement obligation.

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

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

At December 31, 2007, the fair value of the company's retirement plan assets equals $10,469 million. This is the total value of the assets the company reserves for the satisfaction of its retirement plan obligations, primarily consisting of contributions made by the employer and the gains resulting from the investment of these contributions in other assets.

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

In 2006, the expected return on plant assets was $701 million, while the actual return recorded was $966 million. In 2007, the expected return was $809 million, and the actual return was $743 million. The difference between expected and actual returns, in 2006, is a significant difference, because it represents a $265 million increase in investment return over the expected return, which accounts for

approximately a 3.2 percent increase in the assets of the retirement plan. The 2007 return of $66 million less than projected, is, in my opinion, not a significant difference, as the difference in return is just over one-half a percent of the plan's total beginning assets in 2007.

In my opinion, the Actual Return on Plan Assets is a better reflection of the company's financial position, as the actual return is the return that impacts the balance of the company's Plan Assets, directly affecting the company's ability to satisfy its obligations to the plan's beneficiaries.

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

In 2006, plan participant contributions totaled $306 million. In 2007, these contributions were $379 million, representing a 23.9 percent increase in contributions by employees and the company.

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

The investments in the company's retirement plan assets consist of 79 percent equity securities and 21 percent debt securities.

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

In 2007, the company's retirement plan is under-funded by $1,533 million, as the projected obligation is $12,002 million and the plan assets are only $10,469 million. In 2006, the retirement plan was under-funded by $2,122 million.

The funded status of the company's retirement plan appears on the balance sheet under the line item "Employee related obligations," in the Long-term Liabilities section.

Ian Ulmer

Case #11

On the Balance Sheet Model of Financial Reporting

April 28, 2019

I. Summary

Dichev and Penman prelude their work by providing important contextual information that informs the reader as to why the paper was written. As the authors state, the U.S Financial Accounting Standards Board (FASB) and its international counter-part, the International Accounting Standards Board (IASB) are making plans to adjust their respective conceptual frameworks in order to facilitate the gradual melding of the two frameworks into a unified accounting conceptual framework, making compliance for companies operating in regions with different governing accounting bodies much simpler, and, more importantly, forming a common conceptual basis upon which to further develop unified guidance on specific issues. Given that the such fundamental concepts as the defining of Assets and Liabilities is a potential area of modification for the sake of unification, the authors note that the continuing process of convergence of the two conceptual frameworks is likely to be an undertaking that will have as significant an impact on U.S accounting practices as the establishment of the FASB, with its authority and sufficient resources to establish new accounting standards and develop the beginnings of a conceptual framework, did in the 1970's.

The authors make it clear they support the idea of a unified accounting framework whole-heartedly, for the reasons noted above, but they also express a caveat: the push towards a unified framework should only be attempted if the new framework will be built around the right set of core principles. The current system is built around the balance-sheet approach to accounting, but the authors contend that the income statement approach is a much more effective standard around which to build a conceptual framework.

The current balance sheet-based approach, the authors say, is defined by the view that the primary goal of financial accounting is to assign values to assets and liabilities, which has the effect of creating a valuation of earnings for the period. This approach contends that the earnings of a company's is the

change in net assets for a given period, excluding transactions with shareholders, such as distributions and contributions. This argument is further clarified by the authors, saying, “Earnings is a ‘change in value’ concept, and it is impossible to define a change in value before one defies what ‘value’ is,” (Dichev 6). This reasoning would give supremacy to the balance sheet accounts, and this was the approach deemed to be most sound by the FASB when time came to choose an approach to build the new conceptual framework upon in the 1970’s.

The income-statement approach, advocated for by the authors, holds the opposite view. Per the income-statement approach, the most important aspect of financial reporting is the computation and reporting of a company’s periodic revenues and expenses, of which earnings is the bottom-line by-product. As every accounting text states, the two primary guidelines of recording a company’s period transactions are revenue recognition principle, which states that revenue is recognized in the period in which it is earned, and the matching principle, which states that expenses are recorded in the same period as the associated revenue. Under this model, rather than be the primary reporting concern, assets and liabilities arise primarily as an effect of the accruing of revenues and expenses. The authors cite the example of accounts receivable, which occur because revenue is accrued before the associated payment is received.

The authors’ opposition to the balance sheet-approach is based upon four core arguments: that the balance sheet-approach is at odds with how most businesses operate, create value, and are managed; that it can be argued that the concept of income provides a clearer foundation for financial reporting; that the balance sheet-approach is a major factor in the decline of the forward-looking utility of earnings figures; and that there are significant issues in the practical exercise of the balance sheet-approach. These arguments will be summarized in the following paragraphs.

The first opposition point revolves around the notion that the balance sheet-approach runs contrary to the methods by which most businesses conduct their operations. The authors argue that businesses are, at the most basic level, entities that incur costs (expenses) in order to gain a return (revenue). In this sense, generation of revenues and expenses are the primary goal of a business, and the balance sheet entities, assets and liabilities, serve as a means to support these activities. Since a revenue and expense focused stance is the method practiced by most businesses, the authors argue that this should be the approach favored by the FASB and other accounting governing bodies, as well.

The second opposition largely revolves around the idea that, in the authors' opinion, the balance sheet-approach does not demonstrate a clear superiority from an efficacy standpoint. As previously noted, FASB takes the view that earnings are subordinate to assets, as earnings are a measure of the change in value, and thus cannot be measured without establishing what "value" is in the first place, leading to the idea of asset valuation. The weak point in the argument, per the paper, lies in the lack of distinction between assets and earnings. Per FASB, assets are "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events," and the authors express belief that the "benefits" FASB refers to indicate the earnings of a company, leading to circular reasoning that fails to justify the preference for the balance sheet-approach. As the authors put it, "The FASB argues that asset-oriented accounting is superior to income-oriented accounting because one needs to define assets before one can define earnings, then proceeds to define assets in terms of expected earnings" (Dichev 15). Indeed, this is in line with the most widely accepted theories of valuation, in which the present value of an object, or asset, if you will, is the result of the computation of the discounted expected future economic benefits (earnings) of that object. If, conceptually, assets and earnings are linked in such as fundamental way, it would seem counterproductive to base method preference on flawed reasoning, so the answer must lie in the method that provides the most utility.

The authors base their argument for the superiority of the income-statement approach lies in the ability to more accurately value the operations of a company. Conceptually, the income of a company is fairly easy to measure, notwithstanding technical challenges unique to valuation models, and such principles of income measurement are applicable from the smallest businesses to the largest. In contrast, the asset-oriented approach is more complex in execution due to the growing difficulty in providing an accurate valuation for a company's total assets. The valuation for the assets of a small grocery store may be simple to compute, but the authors cite the example of Microsoft as example of the difficulties of asset valuation that result from scale. Given the growing relevance of intangible assets and other difficult to quantify factors that determine the profitability of large companies, asset valuation cannot totally account for the success of a company, which is illustrated by the concept of market-to-book ratios. This ratio measures the relationship between a company's market price per share, which is what investors are willing to pay for a share in the company's future expected earnings, and its book value per share, which is the value of a firm's assets divided equally amongst all outstanding shares. In many of the largest companies, the market value of its shares far exceeds the book value, indicating that something is driving the success of a firm beyond its assets.

The third prong of the authors' opposition to the balance sheet-approach is based in the theory that balance sheet accounting is "likely a major contributor to the substantial temporal decline in the forward-looking usefulness of earnings," (Dichev 16). In financial analysis, the single most important factor in the evaluation of a potential investment is the projected future earnings of that investment; after all, the point of making an investment is to earn a return. However, under balance sheet accounting, earnings are viewed as a by-product of the change in asset valuation over a period. In isolation, such a principle may not pose as significant a problem, but financial accounting does not exist in a bubble, and the principles by which assets are valued and accounted for are significantly impacted by the market environment in which firms operate, an environment that is prone to frequent and

dramatic change. Sudden swings in the market can have an adverse or beneficial effect on the fair value, also known as market value, of a company's assets, which is problematic if earnings, the metric relied upon by investors, is viewed as the product of the net change in the value of assets.

A study by Dichev and Tang examines the impact of this phenomenon, and the results support the authors' conjecture. The study found that, over the last four decades, earnings volatility, the change in reported earnings of a firm from year-to-year, has doubled among the one thousand largest companies in the U.S. The problem lies in the fact that over this same period, the relatively small changes in revenues, expenses, and cash flows cannot account for the substantial fluctuations in earnings year-over-year. The study concludes that much of the unexplained volatility in earnings is attributable to asset revaluations that result in write-offs, adjustments, and similar non-recurring events, which are a direct result of balance sheet orientation in accounting practice. The consequence of this practice will be a diminished utility of earnings figures for evaluation financial entities into the future.

The final point of the paper's stance against the balance sheet-approach concerns the practical application of the method to the accounting practice. The difficultly in properly estimating the fair value of certain assets has already been discussed in detail, and such difficulty, coupled with the necessity of assigning a value to such assets, invariably leads to valuations that are subject to significant managerial influence. Estimations are inherently subject to potential error, or, in the worst case, manipulation by management, such as with the Enron case. The authors of the paper acknowledge this well-known risk but contend that there is another significant risk posed by balance sheet accounting: the potential for market values to grossly distort the value of assets, which in turn will distort earnings. The authors simplify the problems as a positive feedback cycle in which markets positively or negatively impact the value of assets, which, in turn, have a corresponding impact of a firm's earnings, which, further in turn, impact the overall market. The cycle then repeats, creating an artificial increase or decrease in all factors

involved. This phenomenon poses a grave risk to the functional integrity of the practice of financial accounting if left unchecked.

The authors acknowledge that any potential solution will be subject to biases towards a specific party, so the authors choose to take up the advocacy of a preferable solution for the outside investors, which seems appropriate, given that the objective of financial accounting is to provide information about the financial position of the company to investors and creditors. The solution that the authors propose hinges upon two main principles: the distinction between operating and financing activities, and the emphasis of the matching and revenue recognition principles as the basis for accounting for operating activities.

The first part of the solution is to draw a distinction between the operating and financing activities of the firm, a model in which “operating activities” will now encompass both operating and investing activities. The divide will be based on the characteristics of the activity and corresponding resources. Operating activities are defined by the author as activities in which the assets consumed have the singular purpose of existing to support the operations of the firm, and, as such, have minimal value as stores of value. Put more simply, the company intends to consume the operating assets, so their “fair value” should be of little concern to the company. Financing activities, on the other hand, concern resources such as cash (and its equivalents), marketable securities, and receivables accounts, which have value independent of the firm. The value of financing assets is subject to much more influence from external factors, such as overall market conditions, and therefore do not accurately reflect the results of the core business operations of the company.

These two categories of financial information should be reported separately in order to give the investors a clearer picture of not only the company’s overall financial position, but also the factors that make up that overall position. Under this new method of financial reporting, the results of the

company's core business operations would be separated from all of the extraneous one-off write offs, re-valuations, and gains and losses that have the potential to greatly impact the current bottom-line number and would be clearly presented for the investor. The value in this approach lies in the fact that such a disclosure would allow investors to make predictions about a company's future performance regarding core operations, while being about to separately make predictions concerning the above-mentioned non-reoccurring events.

The second prong of the authors' proposed solution hinges upon a greater emphasis on the matching and revenue-recognition principles when companies are accounting for operating activities. In their analysis of this issue and its current implementation in the accounting standards, the authors concur that the revenue-recognition is well-implemented under the current system, but the matching principle could be improved upon, if not in theory, then in practice. The crux of the shortcomings of the matching principle lie in the difficulties inherit in matching some specific expenses with specific revenues. The authors do not propose a radical change to the matching principle, but rather insist that a more central position within the new conceptual framework would provide great benefits for business and investors.

II. Response

This paper had a significant impact on my current thinking about the structure of the practice of accounting, in that it introduced me to a profound issue within the profession of which I was previously unaware. In my study of the particulars of the various financial statements that accountants evaluate and prepare, and, in a broader sense, the conceptual framework that governs the practices, exceptions, and innovations that impact the profession daily, I never came to think of one particular statement as having primacy of place as regarding how accounting is done, for lack of a better phrase. Given how much time is spent studying how asset valuations and impairments and write-offs impact a company's

financial position, I suppose that all of the pieces of the issue are there, but it took this paper that connect all of the disparate pieces into a cohesive whole and communicate the issue to me.

When thinking about the information that investors, whether institutional investors or individuals, would find most important, I would naturally gravitate towards the company's earnings, as this is one of the single largest factors that influence a company's stock price, which is of significant interest to investors in that company. This chain of logic, albeit simplified, lead me to assume that the income statement, if any statement, or concept, would hold a more prominent position in how the conceptual framework is structured. Given that the purpose of accounting is to provide information about companies, and that the focus of most companies is to create earnings by generating revenues and incurring expenses, it would seem to me that it would be most appropriate for the accounting for these companies to follow the focus of these companies and build the conceptual framework around revenues and expenses. Throughout all of the accounting courses that I have taken, earnings, conceptually, has seemed to align more with the income-statement approach to accounting, as the residual value of a company's revenues during a period, minus the company's expenses. Indeed, the concept of earnings being a "change in assets" makes certain sense, from a theoretical standpoint, but, in my opinion, adds another layer of vagueness and estimation to the computation, given the fluid nature of asset valuation.

As I stated before, I had not, previously, spent a considerable amount of time considering the wider issue which the authors address in their publication; I was unaware that the divide between reporting for balance sheet accounts and income statement accounts had so significant an impact on the way that the conceptual framework was, and continues to be, developed. This lack of a position on the issue put me a place where I was not beholden to one approach or the other before reading the paper, but the process of working this case did convince me that the authors raise important points about the current means of accounting for the finances of a business, and that alternatives to the current balance sheet

approach that the conceptual framework is based upon should be seriously considered by the FASB, IASB, and the other governing bodies of accounting entities as they make the attempt to create a unified global standard for accounting practices.

III. Impact

As is apparent from the breadth of issues that the FASB and IASB are considering for re-evaluation in the process of merging accounting frameworks, right down to the potential reconsideration of what comprises fundamental concepts like "Assets" and "Liabilities," the conclusions that the FASB reach during this process will have far-reaching implications for the entire accounting profession for years to come. As newly minted CPAs, we will be witnessing this process first-hand, and the challenges and opportunities that will arise will allow us to add significant value to our firms and clients.

The issues that were addressed in this paper, particularly considering the impact that continued application of the balance-sheet approach could potentially have on the usefulness of the earnings reporting of companies, will have a large impact on how I go about my career in accounting post-graduation. Advising clients is a significant aspect of the responsibilities of an accounting firm, and CPAs must be prepared to offer solutions in response to changes in the business environment, within which fundamental changes in how accounting practices are implement would certainly be considered. Depending on the future decisions that are made by the FASB concerning the construction of the conceptual framework, and perhaps regardless, there may be opportunities to for companies to provide more insightful financial information to their investors, and accounting professionals should be prepared to take advantage of those opportunities.

If, in the future, the balance-sheet approach continues to be the basis for the accounting process, and Dichev and Penman are correct in their predictions that this will result in decreased usefulness of the

earnings numbers given by companies, it may be appropriate for CPAs advising clients to recommend that the clients adopt some of the practices recommended by the authors. If future earnings figures are indeed made less useful by the proliferation of one-time write offs, extraneous losses, and other impactful events that are a result of asset valuation adjustments, companies may be benefitted by adopting changes to their financial reporting process. If the principles of financial disclosure remain the same, the companies must absolutely maintain presentation of their financial statements in accordance with GAAP, but the already-prolific addition of supplemental, non-GAAP information within the footnote disclosures provide a precedent for providing information to investors that is based on the income-statement approach, as well. Companies could very well provide documents within the footnotes that present the results of their operations with a clear delineation between the results of normal operations and those arising from the financing activities, in the method suggested by the authors. Would investors not be benefited by a clearer understanding of the financials of a company's core operations, given that these results are more likely to be indicative of a firm's future performance?

Outside of the core responsibilities of the primary public accounting service lines, an understanding of how issues like asset valuation can have a serious impact on a company's financials. In the case of a company acquiring another company, there must be analysis done of the target company's financial position before an ultimate decision is made on whether or not the acquisition will move forward, and for those accountants responsible for assisting with the target evaluation, the ability to separate out the company's core earnings figures from all of the noise surrounding them may provide the client with a greater understanding of the business operations of the company that they intend to acquire. Accountants with these skills will prove to be invaluable to their employers. If ever I am in the position where I'm part of the team doing the due diligence for an acquisition, the knowledge that the conceptual framework, as it currently stands, can obscure very important information about the target

company will certainly color my approach to the task, and will ensure that I make evaluations based on the alternative approaches, if it appears that such action may benefit my client.

The most unlikely scenario in which knowledge of the nuances of the conceptual framework foundation will impact my career is the scenario in which I, one day, find myself in a position on a board or development group or other regulatory body, perhaps like the group responsible for coordinating with international counterparts in the process of merging different global accounting standings. In such a situation, an understanding of what conceptual foundations the framework is built around will provide me with invaluable perspective in how I execute my responsibilities. From what I gather from the paper's introduction, the authors do not believe that the FASB is even considering a change to the guiding principle of the framework, which seems like an oversight, given the incredible breadth of issues that are on the table for re-definition. If I ever find myself in such a position, I would have to give serious thought to any alternatives to the current process, if those alternatives have the potential to benefit the profession and our clients, if for no other reason than to spark a debate among my colleagues regarding ways to improve the current processes. The accounting profession has been notoriously slow to change, and it appears that over forty years of basing the conceptual framework on one particular approach has created a powerful resistance to change, but we cannot turn a blind eye to the issues that may potentially arise, in the future, as a result of our actions today. If I am even in a position to influence such an important issue, academic work, such as this, will play in important role in informing my actions.

The potential impact that this work will have on my future as a professional may be difficult to predict now, but I feel that any experience that forces me to adapt my thinking and continue to try to find new ways to solve problems is invaluable. As I wrote earlier, this was an issue that I was previous nearly unaware of, and this work gave me a new perspective on a serious issue that will have a significant impact on my future job performance, and the environment in which I will be working.

Ian Ulmer

Case #12

Google Inc. – Earnings Announcements and Information Environment

May 3, 2019

I. Introduction

The purpose of Case #12, Google Inc., is to introduce students to the concepts of earnings statements and the impact that such statements can have on a company's stock price. During the study of the case, students will come to understand the different aspects of the information environment that surround a company's earnings announcement, including the role of securities analysts in evaluating a company's performance and making predictions about future earnings, and the requirements that regulatory bodies impose on companies in regards to the timing and availability of earnings information releases. Students will also gain an understanding of the types of information disclosed within earnings announcements and the difference between earnings figures that comply with GAAP and those figures that are not GAAP compliant, but that are often disclosed by a company within its notes to financial statements. Finally, students will analyze the relationship between earnings announcements and company stock performance, and how the meeting, or missing, of analysts' consensus forecasts can prompt investors to make decisions regarding their investments.

While I was familiar with the concepts of earnings information from Financial Accounting, my only experience was with the computation of the earnings figures; I had very little experience with the process that surrounds the earnings announcements. Likewise, I had a general understanding of the job of a security analyst, but I was unaware that so many large companies have only a small number of analysts following them until I began research for this case. But perhaps the most informative part of completing this case was gaining an understanding of the differences between GAAP and non-GAAP figures used by companies. In the academic sphere, we are primarily concerned with gaining an understanding of GAAP and how it applies to all aspects of financial reporting, but little time is devoted to the study of non-GAAP measures. This case gave me an understanding of the composition and importance of non-GAAP measures, given how widespread their use is in the financial reporting of

public companies. In the business world, the additional disclosure of non-GAAP financial figures can give investors a much more comprehensive view of the financial position of a company, as that information can remove much of the extraneous, one-time gains and losses to due assets sales, revaluations, and similar adjustments, to arrive at figures that more accurately represent the performance of a company resulting from its core operations, which may have much more predictive value for investors.

II. Analysis

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

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

The difference between the GAAP and non-GAAP figures is due to the fact that Google added back Losses on Discontinued Operations, Stock-based Compensation Expenses, and Restructuring Charges (and the associated income tax effects) to Income from Operations and Income Tax. I agree with Google's adjustment of Net Loss from Discontinued Operations and the Restructuring Charges, as these are events that will not carry forward into the future, so their removal will give the investors a more accurate basis for estimating future earnings for the company. However, I do not agree that the company added back expenses arising from stock compensation plans, as these are likely ongoing plans that will continue to impact the company in the future. This objection is based on the fact that

compensation expenses are typically incurred over the years that the company benefits from the service of the employee, which indicates that the company will, most likely, incur a similar charge in the next year, and for an unknown number of years into the future, depending on the details of the plan.

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

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

Google's stock price appears to be positively correlated with its earnings performance, which is appropriate, given that stock price is the number that represents the discounted value of the expected future cash flows of a company. During the lead-up to the third quarter earnings announcement, Google's stock price increased drastically, and, once analysts' expectations were confirmed, the stock price continued to tick higher. When Google reported its fourth quarter earnings at $12.01 a share, adjusted for stock compensation plans and other items, actual earnings did not meet analyst expectation of $12.20 a share, and, subsequently, Google's stock price dipped briefly.

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

During 2013, Google's stock price handily outperformed the NASDAQ index. At year-end 2013, Google's cumulative return since the beginning of 2013 was approximately 55 percent, while the NASDAQ index only notched a 35 percent cumulative return for 2013.

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

Based on the data in the market chart, investors perceived the news contained in Google's fourth quarter earnings press release to be news of a mixed nature, in the immediate aftermath of the announcement, as the stock price declined upon the release, but quickly recovered its loss and began to climb higher. As the Wall Street Journal article noted, the stock price did, briefly, decline as a result of the report of below-expected adjusted earnings figures, but it quickly rebounded due to the abundance of good news contained in the press release, which primarily took the form of the announcement that Google's raw fourth quarter revenue figure topped analyst expectation by $100 million.

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

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

Google's fourth quarter revenue was $16.9 billion, compared to analysts' expectations of $16.8 billion, but actual adjusted earnings of $12.01 a share fell short of the consensus forecast of $12.20 a share. This is consistent with the positive reaction of the stock market, as the price briefly declined upon Google not meeting analysts' expectation for adjusted EPS but moved higher on the basis of the other positive earnings information concerning above-expectation earnings in the report.

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

The WSJ article discusses the 17 percent growth in both revenue and net income, compared to the prior year, as a significant factor in the rise in company stock price, following the earnings call, but also expresses concerns about the company business model for the future. The biggest factor that could be cause for concern is the increasing shift from desktop internet usage to mobile devices, and the potential impact that this shift could have on Google's ad revenue business. While Google's search advertisement engagement increased 31 percent during the period, but the average price that the company received from each click declined by 11 percent, threatening Google's primary revenue stream.

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“On my honor, I have neither given, received, nor witnessed any unauthorized help on this assignment.”

Ian Ulmer