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A Compilation of Case Studies on Modern Issues and Applications of Accounting

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by
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Abstract

Over the academic year spanning from 2018 to 2019, I attained knowledge of the accounting profession and applications of accounting techniques that have arisen from modern needs in the professional world. Having since spent the summer working as an accountant for a private construction company, I have been able to apply the knowledge in a real-world setting. For the thesis requirement, I thoroughly completed case studies on a variety of topics related to accounting. Each of the sections have been completed in case format with attention to readability and thoughtful presentation of information. Every case began with a problem to which my study presented my opinion on how it would best be dealt with by an accountant. With the help of my professors and professional research, I came to educated conclusions about how to best treat the issues discussed in the compilation of case studies.

Table of Contents

Case Study 1

Data Analytics:
Google Fusion

1. Executive Summary

As the business world increasingly seeks web-based solutions for accounting problems, numerous tools have come to market to assist in data analysis and presentation. While the job of an accountant is to assign meaning to specific numbers the entire field of accountants is relying on these emerging technologies to collect, organize, and mine the totality of business data in an efficient and meaningful way. Just merely tracking the millions of financial transactions that occur daily is a daunting task; but, the field of accounting demands its employees go even further than tracking. Beyond keeping up with this heap of data, accountants are expected to recognize trends and patterns which can be difficult to do with an exhaustive list of numbers or information. This demand makes a great case for the employment of one of the newest free tools available for accountants, Google Fusion.

Google Fusion is a cloud-based data storage software linked to GSuite, Google's answer to Microsoft Office 365. The use of the cloud enables a client's data to be simultaneously hosted, managed, shared and published to any user who may benefit. This is not Google's first spreadsheet program, they have long offered Google Sheets as part of the Google Drive repertoire; however, Google Fusion is like Sheets on steroids. Where Google Fusion differentiates itself from Google Sheets is with its advanced visualization features that "translate data to graphical charts, maps, timelines or plots, with the ability to publish, share and integrate them with individual users and websites" ("What is Google Fusion Tables?"). In essence, Google Fusion is an application for translating meaningful business data from tables and converting it into understandable graphics that can be presented and easily interpreted by owners, managers, investors or other capital providers.

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

There are two main uses of this tool that offer benefits to clients: heat/intensity mapping and geographic information systems. Additionally, there are three main characteristics of the software that are advantageous: cloud-based hosting and integration, a consistent repository of data and collaboration potential.

After uploading and attributing a client's data, Google Fusion offers many ways of analyzing the information. The most common visualization tool is the Intensity Map; the intensity map will plot data points relative to their location and compare the total prevalence of data in a single location to the rest of the intensity map. This tool could allow a business to see which parts of the country are buying products at higher rates or which regions have the most outstanding payable accounts. That information aids management in selling and collections decisions. Beyond using geographic data for intensity mapping, representing data on a map could also assist a company in tracking operational costs and progress. This past summer I worked for a construction company managing a 26-mile highway expansion project. One of the largest endeavors on the project was the pouring of concrete barriers on shoulders and medians of the highway. In total the project required over 750,000 linear feet of concrete to be poured and the progress was tracked by interns on two systems: Microstation and Blue Beam. Since these programs did not offer geographic information tracking, employees would have to drive the site and manually track progress with varying degrees of accuracy. If foreman on the jobsite tracked progress in a Google Fusion Table the tracking information would be seamlessly updated making the analysts work easier and the managers decisions more accurate.

Google Fusion Tables work by exporting data from a spreadsheet table and presenting that data in a more usable fashion. Once a client has created a table in either Excel, Access, Spreadsheet or any other spreadsheet application the data must be attributed to verify its source and validity. It is worth noting that Google Fusion also functions as its own data repository. There are many publicly accessible datasets with information ranging from “goals at the world cup” to “coffee production” and “homicides in Colombia” (Steiman, “Google Tables: A Great Tool with the Potential to be Transformative”). This makes Google Fusion not just a tool for translation of data but a point source for data itself through the cloud. Jonathan Steiman points out that one of the biggest opportunities for Google Fusion is in the streamlining of financial and non-financial data; right now, the mobile business network is riddled with millions of data sets that are “silo’d across many systems and written in different formats” (“Google Tables: A Great Tool with the Potential to be Transformative”). If Google Fusion can become a central repository for business data is will make analysis more efficient and accurate.

Finally, the real time basis of Google Fusion means that the data can be accessed at any time by anyone in the client’s business network via the cloud. This feature provides collaborative and integration benefits to users. Since the Google cloud infrastructure is free to use startup costs are low and the accessible data is always “the most update version across all shared users, integrated website or applications” (”What is

Google Fusion Tables?”). Fusion, like Google Docs, allows for real-time collaboration from remote users who can contribute, edit or leave comments on the data without altering the main data set. Since Fusion Tables are exported in “comma-separated-value” there is “a strong focus on being able to merge data from different sources” (Thomas, “Google Fusion Tables: Getting Started”). Simply being a Google solution offers benefits to users who host their websites on Google to integrate graphics online; within Google Fusion there are widgets connected to Google Maps, Google Earth and Google Drive that appeal to clients who already utilize the expansive Google toolbox.

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

Auditing

Google Fusion could prove to be a useful tool for companies seeking auditing assistance from a web-based software solution. The goal of auditing for a client is to examine financial data to ensure that the company’s books are accurate and in compliance. Most benefits derived from Google Fusion will benefit data accuracy as opposed to compliance. Fusion has the ability to process troves of data that by itself may have limited value to users; the system is designed to draw meaningful conclusions to simplify and present a company’s data portfolio in the simplest way possible. The collaborative nature of Fusion tables provide a meaningful internal control to data inputs, managers can track past and present changes and assess their validity and accuracy before the data impacts the cost report or financial statements. Since source data is tracked as well, managers would have little trouble identifying the source of discrepancies and making needed changes. The construction of high quality geographic information will also assist in forecasting decisions of auditors. An intensity map that shows the areas with high propensities of returns would allow managers to anticipate and account for those expected events with an account for Returns and Allowances.

Tax Planning

The benefits of Google Fusion to Tax Planning are less obvious but would also link to Geographic Data Analysis and meaningful data condensation. For businesses seeking to expand to new domestic markets they could create a Fusion table that breaks down local tax exposure so they can make an informed decision on how to minimize tax liability. For global expansion a company could create a graphic which displays tariffs or other economic barriers that a company should be aware of prior to making a decision to expand or relocate. The accurate real time tracking of costs presents an inherent advantage to tax preparers who often try to estimate tax liability from incomplete data sources.

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

Google Fusion Tables offer benefits for operational employees and managers of a company that promote accuracy, efficiency and understandability. Google Fusion Tables can be used by clients with little-to-no upfront capital investment or training. The system integrates with other CSV spreadsheet software and can convert source data into vibrant visual elements. The most unique feature of Google Fusion is its compatibility with

Google Earth through Geographic Information Systems that allows data to be shown with geographic relevance. For managers, Google Fusion allows financial information to be broken down by country, state, county, or municipality to create a visual story that supports numerical data with little inherent value to users. Information about favorable sales trends in a region can be presented to investors to acquire additional stockholder capital or to show reasonable support for a capital investment project to a weary lender. By tracking operational data, managers and lower level employees can easily interpret what progress has been made and what work is yet to be done. Through “multilayered visualizations that combine data from multiple sources” our firm could pair a client’s transactional data with web-mapping technology to “analyze geodata and create interactive, mobile-ready maps that communicate ideas better than ever before” (Vanhorn, “Google Fusion Tables with Google spreadsheets”). With access and knowledge of Google Fusion, accountants will have exciting new tools that can potentially lower a company’s bottom line or attract external capital by simplifying otherwise uninterpretable data in a common-sense format.

Case Study 2

Rocky Mountain Chocolate Factory, Inc:
Preparing Financial Statements

1. Executive Summary

This case, which analyzed the financial position of Rocky Mountain Chocolate Factory, Inc., was excellent practice for not only preparing financial statements but also for preparing temporary accounts at period end. Since some accounts, like expenses and revenues, are temporary by nature they are closed out at the end of each period and that must be done to accurately account for net income. In terms of accounting concepts, I solidified my understanding of how various accounts flow through the supply chain and how that effects the presentation of financial reports.

This exercise also solidified much of the Excel knowledge that I had and tested my ability to improvise new methods given what I already knew. One of my favorite parts of preparing the statements and journal was the formatting because I view understandability as a central pillar of financial reports. The information is only as valuable as the information that users derive from it and thus, it is imperative to make the data easy to follow and interpret. I did this by using cell styles, alignment and number formats. Using a consistent style and format across the statements makes them easily comparable.

Finally, this exercise made me consider which portion of the business is affected by various cash transactions. All of the operational accounts have to do with the money that relates to the normal and ongoing operations in the company. Investing activities include stock, retained earnings and long-term payables while financing activities related to PPE. I knew how these were classified but had never visualized why it is beneficial to see the effects of different portions of the company separately as opposed to just looking at the total of income.

On the balance sheet I am expecting to see an inventory account as well as property, plant and equipment due to the nature of their candy manufacturing business. I also expect that since they franchise their brand there will be expenses and revenue from franchising fees. Since they are a large corporation there will be common stock and additional paid in capital that they use to finance operations. They also likely have a high accounts receivable balance since they sell goods on account to their franchise stores. The major assets are going to be the cash account and accounts/notes receivable since those are driven by operations. Other major asset accounts will be the inventory on hand and the property plant and equipment since they support a manufacturing process. Rocky Mountain's major liabilities are their accounts payable to suppliers of ingredients, for example, and the dividend payables since they have common stockholders. They also have two accrual accounts that are significant liabilities: accrued salary and wage expenses and other accrued expenses.

From steps B and C I noticed three adjusting entries that may need to be made based upon the companies accounting methods. The accrued wages will need to be closed out to account for the wage expenses in the period; they will need to be paid with cash so they need to be allocated to the appropriate expense accounts. Since the company has a significant value of property, plant and equipment they will also need to adjust for the period's depreciation expense. Finally, there may need to be adjustments made to the inventory count following a physical inventory being taken; the difference will need to be deducted from inventory to accurately calculate the period's product cost.

2. Unadjusted Trial Balance

		Unadjusted Trial Balance												
		Beg Balance	1. Purchase Inventory	2. Incur Factory Wages	3. Sell Inventory for cash and on account	4. Pay for Inventory	5. Collect Recievables	6. Incur SG&A (cash and payable	7. Pay Wages	8. Receive Franchise Fee	9. Purchase PPE	10. Dividends declared and paid	11. All Other Transactions	Unadjusted Trial Balance
DR	Cash and Cash Equivalents	$ 1,253,947			$ 17,000,000	$(8,200,000)	$ 4,100,000	$ (2,000,000)	$(6,423,789)	$ 125,000	$ (498,832)	$(2,403,458)	$ 790,224	$ 3,743,092
	Accounts Recievable	$ 4,229,733			$ 5,000,000		$ (4,100,000)						$ (702,207)	$ 4,427,526
	Notes Recievable, current	$ -											$ 91,059	$ 91,059
	Inventories	$ 4,064,611	$7,500,000	$6,000,000	$(14,000,000)								$ (66,328)	$ 3,498,283
	Deffered Income Taxes	$ 369,197											$ 92,052	$ 461,249
	Other (Current Asset)	$ 224,378											$ (4,215)	$ 220,163
	Property and Equipment, net	$ 5,253,598									$ 498,832		$ 132,859	$ 5,885,289
	Notes Recievable, less current portion	$ 124,452											$ 139,198	$ 263,650
	Goodwill, net	$ 1,046,944											$ -	$ 1,046,944
	Intangible assets, net	$ 183,135											$ (73,110)	$ 110,025
	Other (Non-Current Asset)	$ 91,057											$ (3,007)	$ 88,050
CR	Accounts Payable	$ 1,074,643	$7,500,000			$(8,200,000)							$ 503,189	$ 877,832
	Accrued Salaries and Wages	$ 423,789		$6,000,000					$(6,423,789)				$ -	$ -
	Other accrued expenses	$ 531,941						$ 3,300,000					$(2,885,413)	$ 946,528
	Dividend payable	$ 598,986										$ 3,709	$ (1)	$ 602,694
	Deffered Income	$ 142,000								$ 125,000			$ (46,062)	$ 220,938
	Deffered Income Taxes	$ 827,700											$ 66,729	$ 894,429
	Common Stock	$ 179,696											$ 1,112	$ 180,808
	Additional Paid in Capital	$ 7,311,280											$ 315,322	$ 7,626,602
	Retained Earnings	$ 5,751,017										$(2,407,167)	$ -	$ 3,343,850
	Sales	$ -			$ 22,000,000								$ 944,017	$ 22,944,017
	Franchise and royalty fees	$ -											$ 5,492,531	$ 5,492,531
DR	Cost of Sales	$ -			$ 14,000,000								$ 693,786	$ 14,693,786
	Franchise Costs	$ -											$ 1,499,477	$ 1,499,477
	Sales and Marketing	$ -						$ 1,505,431						$ 1,505,431
	General and Administrative	$ -						$ 2,044,569					$ (261,622)	$ 1,782,947
	Retail Operating	$ -						$ 1,750,000						$ 1,750,000
	Depreciation and Amoritization	$ -												$ -
	Interest Income	$ -											$ (27,210)	$ (27,210)
	Income Tax Expense	$ -											$ 2,090,468	$ 2,090,468

3. Adjusted Trial Balance

		Adjusted Trial Balance								
		Unadjusted Trial Balance	12. Adjust for inventory cos	13. Record Depreciation	14. Wage Accrual	15. Consultants Report	Pre-Closing Trial Balance	16. Closing Entry	Post Closing (ending) balanc	Actual Feb 28, 2010 Figures
	Cash and Cash Equivalents	$ 3,743,092					$ 3,743,092		$ 3,743,092	$ 3,743,092
	Accounts Recievable	$ 4,427,526					$ 4,427,526		$ 4,427,526	$ 4,427,526
	Notes Recievable, current	$ 91,059					$ 91,059		$ 91,059	$ 91,059
	Inventories	$ 3,498,283	$ (216,836)				$ 3,281,447		$ 3,281,447	$ 3,281,447
	Deffered Income Taxes	$ 461,249					$ 461,249		$ 461,249	$ 461,249
DR	Other (Current Asset)	$ 220,163					$ 220,163		$ 220,163	$ 220,163
	Property and Equipment, net	$ 5,885,289		$ (698,580)			$ 5,186,709		$ 5,186,709	$ 5,186,709
	Notes Recievable, less current porti	$ 263,650					$ 263,650		$ 263,650	$ 263,650
	Goodwill, net	$ 1,046,944					$ 1,046,944		$ 1,046,944	$ 1,046,944
	Intangible assets, net	$ 110,025					$ 110,025		$ 110,025	$ 110,025
	Other (Non-Current Asset)	$ 88,050					$ 88,050		$ 88,050	$ 88,050
	Accounts Payable	$ 877,832					$ 877,832		$ 877,832	$ 877,832
	Accrued Salaries and Wages	$ -			$ 646,156		$ 646,156		$ 646,156	$ 646,156
	Other accrued expenses	$ 946,528					$ 946,528		$ 946,528	$ 946,528
	Dividend payable	$ 602,694					$ 602,694		$ 602,694	$ 602,694
	Deffered Income	$ 220,938					$ 220,938		$ 220,938	$ 220,938
CR	Deffered Income Taxes	$ 894,429					$ 894,429		$ 894,429	$ 894,429
	Common Stock	$ 180,808					$ 180,808		$ 180,808	$ 180,808
	Additional Paid in Capital	$ 7,626,602					$ 7,626,602		$ 7,626,602	$ 7,626,602
	Retained Earnings	$ 3,343,850					$ 3,343,850	$ 3,580,077	$ 6,923,927	$ 6,923,927
	Sales	$ 22,944,017					$ 22,944,017	$ (22,944,017)	$ -	$ 22,944,017
	Franchise and royalty fees	$ 5,492,531					$ 5,492,531	$ (5,492,531)	$ -	$ 5,492,531
	Cost of Sales	$ 14,693,786	$ 216,836				$ 14,910,622	$ (14,910,622)	$ -	$ 14,910,622
	Franchise Costs	$ 1,499,477					$ 1,499,477	$ (1,499,477)	$ -	$ 1,499,477
	Sales and Marketing	$ 1,505,431					$ 1,505,431	$ (1,505,431)	$ -	$ 1,505,431
	General and Administrative	$ 1,782,947			$ 639,200		$ 2,422,147	$ (2,422,147)	$ -	$ 2,422,147
DR	Retail Operating	$ 1,750,000			$ 6,956		$ 1,756,956	$ (1,756,956)	$ -	$ 1,756,956
	Depreciation and Amoritization	$ -		$ 698,580			$ 698,580	$ (698,580)	$ -	$ 698,580
	Interest Income	$ (27,210)					$ (27,210)	$ 27,210	$ -	$ (27,210)
	Income Tax Expense	$ 2,090,468					$ 2,090,468	$ (2,090,468)	$ -	$ 2,090,468
							$ 28,436,548	$ 24,856,471		

4. Income Statement

Rocky Mountain Chocolate Factory Inc.		
Income Statement		
FYE February 28, 2010		
Revenues		
Sales	$	22,944,017
Franchise and Royalty Fees	$	5,492,531
Total Revenue	$	28,436,548
Cost and Expense		
Cost of Sales	$	14,910,622
Franchise Costs	$	1,499,477
Sales and Marketing	$	1,505,431
General and Administrative	$	2,422,147
Retail Operating	$	1,756,956
Depreciation and Amoritization	$	698,580
Total Cost and Expenses	$	22,793,213
Total Operating Income	$	5,643,335
Other Income		
Interest Income	$	27,210
Total Other Expenses (Income)	$	27,210
Income Before Tax	$	5,670,545
Income Tax Expense	$	(2,090,468)
Net Income	$	3,580,077

5. Balance Sheet

Rocky Mountain Chocolate Factory Inc.		
Balance Sheet		
As of February 28, 2010		
Current Assets		
Cash and Cash Equivalents	$	3,743,092
Accounts Recievable	$	4,427,526
Notes Recievable, current	$	91,059
Inventories	$	3,281,447
Deffered Income Taxes	$	461,249
Other (Current Asset)	$	220,163
Total Current Assets	**$**	**12,224,536**
Other Assets		
Notes Recievable, less current portion	$	263,650
Goodwill, net	$	1,046,944
Intangible assets, net	$	110,025
Other (Non-Current Asset)	$	88,050
Total Other Assets	**$**	**1,508,669**
Property and Equipment	**$**	**5,186,709**
Total Assets	**$**	**18,919,914**
Liabilities		
Accounts Payable	$	877,832
Accrued Salaries and Wages	$	646,156
Other accrued expenses	$	946,528
Dividend payable	$	602,694
Deffered Income	$	220,938
Deffered Income Taxes	$	894,429
Total Liabilities	**$**	**4,188,577**
Stockholder Equity		
Common Stock	$	180,808
Additional Paid in Capital	$	7,626,602
Retained Earnings	$	6,923,927
Total Stockholder Equity	**$**	**14,731,337**
Total Liabilities and Stockholder Equity	**$**	**18,919,914**

6. Cash Flow Classification

Balance Sheet Accounts	Operating	Investing	Financing
Cash and Cash Equivalents			
Accounts Recievable	X		
Notes Recievable, current	X		
Inventories	X		
Deffered Income Taxes	X		
Other (Current Asset)			
Notes Recievable, less current portion			X
Goodwill, net			
Intangible assets, net			
Other (Non-Current Asset)			
Property and Equipment		X	
Accounts Payable	X		
Accrued Salaries and Wages	X		
Other accrued expenses	X		
Dividend payable	X		
Deffered Income	X		
Deffered Income Taxes	X		
Common Stock			X
Additional Paid in Capital			X
Retained Earnings			X

Income Statement Accounts	Operating	Investing	Financing
Sales			
Franchise and Royalty Fees			
Cost of Sales			
Franchise Costs			
Sales and Marketing			
General and Administrative			
Retail Operating			
Depreciation and Amoritization	X		
Interest Income			
Income Before Tax			
Income Tax Expense			
Net Income	X		

Case Study 3

In-Class Debates Regarding the Accounting Profession

1. Executive Summary

For this third case, Dr. Dickinson turned the class room into a forum and asked us the tough questions that many of us have grappled with ourselves. We discussed the long-term costs and benefits of a profession in public accounting as opposed to various other financial or legal routes. We deliberated about the short-term value of getting a degree in accounting by looking at the internship opportunities that are exclusive to our major and considered the long term value that can arise if we thoughtfully consider where to accept our offers at, because it is likely to become a home base for some time.

2. Scenario 1

Overview: The first scenario is a conversation that is overheard between two accounting students in Conner Hall. Erik starts by telling Delaney that he is going to law school after he graduates from Ole Miss. He continues, saying that he is going to practice tax law in New York City. Delaney replies by suggesting that Erik look into getting his masters in Tax at Ole Miss because it is a smaller commitment of time and money. Erik replies that he knows a friend who does tax law in New York that makes way more money than an accountant. Delaney shares her view that Erik will miss out by not taking an internship with a Big 4 firm to which Erik replies he still intends to do so. We were asked whether we thought Erik's argument had merit or not.

Class discussion: The class discussion on this scenario largely centered around whether a pay gap truly does exist, how the legal and public accounting fields differ and the merits of Erik taking a Big 4 internship from another accounting student who may intend to work for that company in the long term. Dr. Dickinson was adamant that while accountants may start out making less than lawyers, the combination of the savings from foregoing law school and the opportunities for advancement narrow that gap to an insignificant amount. The initial reaction that I shared was that this question had more to do with occupational preference: Erik should decide if he wants to be a tax lawyer or if he wants to be a tax accountant. Dr. Dickinson pointed out that the duties prescribed to each title likely have far more in common than they do apart. Finally, the class mostly agreed that a law degree would allow for more mobility if tax is not a life-long plan.

My answer: Erik is justified in his decision to pursue tax law if that is his aspiration, there is not conflict with majoring in accounting. But, he should be weary of taking an internship with a Big 4 firm if he does not intend to work in public accounting in the long-term.

3. Scenario 2

Overview: The second scenario is another overheard conversation, this time between three students. Two girls, Janie and Olivia, are talking about how they are not that into accounting. Janie explains that she wants to do investment banking and Olivia aspires of doing consulting work. A third student, Jones, interjects and encourages the girls to major in finance and consulting, respectively, if they intend to pursue a career in that field. Janie rebukes that investment banks like to hire accounting majors and Olivia is majoring in accounting in hopes that it will help her get into an esteemed MBA program. We were asked to side with the two girls or Jones.

Class Discussion: The most impactful takeaway from the conversation in class was the notion that accounting is an inherently versatile degree; Dr. Dickinson described it as a portable degree. There are many merits to the girl's belief that majoring in accounting will open them up to avenues that a finance degree or consulting focus would not on their own while not diminishing their chances of getting a job in their target industries. In fact, an argument was made that a degree from the Patterson School of Accounting may be more advantageous in the pursuit of landing lucrative banking or consulting jobs. In interacting with the firm's, the girls ought to be honest about their long-term goals; with banking there are merger and acquisition positions that will align well with Janie's vision as long as she is honest with the firm about what she wants.

My Answer: I think that the girls were smart to major in accounting; in fact, I came to college as dual major in managerial finance and banking and finance and switched to accounting after realizing the advantages to the program and curriculum.

4. Scenario 3

Overview: The third scenario involves a past-student who recently completed their internship with a Big 4 firm in Washington DC. The student emails Dr. Dickinson explaining that while they enjoyed their time in DC and learned a lot they see themselves working long-term back in their hometown of Dallas. Dr. Dickinson replies to the student and encourages them to stay with a Big 4 firm and contact a recruiter about a relocation request. Dr. Dickinson is honest with the student, admitting that it is going to be very difficult to get a transfer to Dallas since it is a very competitive office. She tells the student that it would have been wise to pick Dallas for their internship if they hoped to work their in the long term because now the DC office is heavily invested into them and likely intends to recoup that cost. The student replies saying that while they originally wanted a new environment after their internship they needed to go home, even if that meant giving up a position with the Big 4 firm. We were asked if we believed the student had merits to their argument and if they went about it correctly.

Class Discussion: The main argument against the student was that they would have benefited more from speaking directly to someone in the D.C. office during the internship at the point that they realized they did not want to stay at that location long-term. Dr. Dickinson has no bearing on the student's outcome and cannot tell the student with any accuracy if they have a chance of transferring to Dallas. These conversations are best suited for a face to face interaction with a member of management whom you developed a relationship with during the internship. It seems like the student shied away from a tough conversation because they were afraid that their request may not have been well received. This was an interesting part of class because Dr. Dickinson revealed to us that the Big 4 companies spend an average of $175,000 for every recruit that they offer on of their coveted internship spots to. In order for them to recover that investment a recruit has to stay with the company for at least 3 years.

My Answer: I think this student made many mistakes in their approach to this situation. Last summer I interned for a construction company called Kiewit Corporation in Dallas, Texas. I actively sought out the company but after getting the job I was told which location I would work at. Over the summer I came to love the company but realized that Dallas was not my ideal location for a variety of reasons. I scheduled a close-out meeting with my supervisor to reflect on the summer and in the meeting, I told her that I had aspirations of moving forward with the company but that I would like to do so in a new setting with exposure to a different set of projects. When I got my offer back at the beginning of the year they told me to decide my location; that is the value of having a tough conversation.

5. What I Learned from the Case

Case 1 Lesson:

Studying accounting is a great choice for a student that wants to study tax law. I have always heard that you can major in anything and go to law school; that being said, it is hard to imagine that Erik could get a more applicable education during his undergraduate studies than by studying accounting. The discussion in class brought to light that there is no consistent disparity in pay between tax lawyers and tax accountants; thus, Erik's justification on these grounds is misguided. If Erik is more interested in the field of public accounting then he should not choose tax law on the false assumption that it will pay better. From an economic perspective, it is worth emphasizing that a one year masters program would allow a graduate to start producing income two years before a lawyer and avoid accruing two more years of student debt that will accumulate interest. The relationship that Erik imagines having with a Big 4 firm seems impractical; I have doubts that if Erik made clear his true long-term intentions a Big 4 firm would want to commit one of their coveted internship spots to his short-term interest.

Case 2 Lesson:

It was after a conversation with my Accounting 201 teacher Dr. Brett Cantrell that I came to the realization that I would not be sacrificing any opportunities in the banking and finance industry if I chose to pursue a major in accounting. I would however open myself up to some very exclusive positions that accounting majors regularly obtain at Ole Miss. Dr. Dickinson pointed out that at the vast majority of universities in the United States, even the top accounting graduates could only dream of obtaining jobs with the caliber of firm that Ole Miss has forged strong ties with. I would know, my brother graduated last year from Northwest Missouri State with an Accounting degree and a respectable GPA but the possibility of obtaining a Big 4 internship was realistically zero, he had never even been encouraged to try. When I went home for the summer after my sophomore year and told my parents that my older fraternity brothers were interning with companies like KPMG and PwC their jaws dropped. The week that I came back to campus my junior year I switched my major to accounting and have loved it ever since.

Case 3 Lesson:

This scenario and discussion did make me realize that the location we chose for our internship is a consequential decision. Most firm's will only hire full time if you have an internship and the vast majority of the time they will offer a position at the location you performed your internship at. If you had asked me before Wednesday night where I wanted to do my internship I would have said New York; now I am not sure if that is the best location for me because I cannot see myself living in the city for the long term. Most importantly, this scenario emphasizes the importance of building relationships at your internship; if this student had forged trusting bonds with management they surely would have known of a better resource to reach out to than Dr. Dickinson.

Case Study 4

Generic Bank:
Accounting for Debt Securities Sales and Impairments

1. **Executive Summary**

I found this case interesting in coincidence to one of my favorite movies, The Big Short. In the movie a small group of investors decide to short the housing market because they think that mortgage backed securities are poised to fail. This case looks at how banks must report the decline in value of their securities based upon their intent to hold or sell and their faith in the markets ability to recover the losses in a reasonable period of time. If the banks reported that they intended to hold the securities they would not necessarily be required to mark them down to their fair value. But, in the case that the bank changed their mind and decided that they wanted to sell one of their securities they are likely required by principle to mark down their entire portfolio of securities.

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 the seven securities designated above in 20x2?**

If Joshua Winters moves forward with his strategy to sell the seven mentioned securities in early 20X3 then Generic Bank would have an impairment loss on five of the securities (003, 015, 025, 030, 076) and realize an outright gain on the sale of two securities (067, 096). The two criteria for Generic Bank to claim that the loss on the security should be deemed as an impaired loss (and thus adjusted to fair value through an allowance for credit loss) are either that the loss in value of the security was the result of the security holder's credit loss or that the bank no longer has an intent or ability to hold the security until the unrealized loss can cover the amortized costs. Since Winters made it clear that Generic Bank does not have the any intent of holding the security it should be adjusted to reflect the deviation from fair value and the allowance should be classified as an impairment. General Bank's desire to sell the securities is the result of the institution's current strategy and is in line with the normal business dealings of the company so the transactions are considered normal.

FASB chair Russell Golden remarked that the ASU "aligns accounting with the economics of lending by requiring banks and other lending institutions to immediately record the full amount of credit losses that are expected in their loan portfolios, providing investors with better information about those losses on a timelier basis" (FASB News Release 06/16/16). In the case of Generic Bank, even though Winters is not going to sell the securities until the beginning of 20X3, they must report an impairment loss on the five designated securities because they decided in period 20X2 that they no longer intended or had the ability to recover the loss. For the sake of fair reporting and given the stated strategic goal of Generic Bank the most accurate end of year financial reporting will require that the transactions coordinated in year 20X2 impact period end financial statements and capture an accurate financial position as the bank begins acquisition work in the first half of 20X3. If the bank were to wait until 20X3 to start reporting both sales of securities and new acquisitions the financial statements would capture the cause and the effect, making the impact of each individually more difficult to ascertain.

At the point that Generic Bank realizes that it cannot recover its loss on a mortgage-backed-security or bond it has a responsibility to inform its stakeholders of its intention to classify the difference as an allowance for credit loss. Prior to the recognition of ASU 326-30, accounting standards boards would often heard complaints that "financial institutions … could not record credit losses that they were expecting but had not yet met the probable threshold" (Financial Instruments—Credit Losses). The greatest advantage to this standards update is that it will demand more current tracking of a company's total value in securities. Now, Generic Bank can "also record reversals of credit losses in situations in which estimates of credit losses decline in the current period net income" (Financial Instruments—Credit Losses, ASU 326-30). Since Generic Bank is not planning to sell the securities until early 20X3, they could continue to adjust AFS securities and allowances until 12/31/20X2. In the event of an immediate favorable credit environment, this strategy will present financials as more favorable than if the entire value was immediately written off prior to year-end.

3. **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?**

Other than the seven securities that winters highlighted for sale, I must assume that the remaining 93 securities all have an intention of being held to maturity. The two qualifiers of an impairment loss are a credit loss that has hindered the ability to meet the securities obligation and an unwillingness on the part of the security holder to maintain the security until the loss is recovered. In terms of assessing if an externality caused a credit loss the Table 2 data gives a broad overview of the current and stated values of securities; by looking at the values I notice that in general municipal bonds and US treasury securities are relatively stable. However, it is hard to say whether the decline in values of many corporate bonds and mortgage-backed-securities is the outcome of cyclical rate changes or if there is an external reason for the bond issuers decline in expectation of making bond payments. In the case, we learned that Generic Bank believes that most of the decline in value of their securities is the result of changes interest rate and not credit deterioration and we were instructed to assume that there are no present credit losses. Since the other 93 securities are only hindered by market conditions and since Winters is intent on holding the securities then I believe that Generic Bank should only recognize impairment loss for the seven securities that are targeted for sale. After they decide on how to treat this situation they should update their internal controls plan and reporting standards so that future transactions are treated similarly.

4. **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?**

An external auditor is likely to consider a wider array of accounting treatments or funding sources than the banks CFO, who has an inherently limited scope. With that being said, I do not believe that if I assumed the role of Heather Herring my answer to questions directly relating to the sale of AFS securities would shift. Given the updated accounting standards CFOs, regulators and external auditors must all apply the same principles when adjusting for impaired securities. Heather Herring however, may press Joshua Winters to find more impairments than the seven securities that he highlighted. Most likely, Herring and Winters would identify many securities that are suffering impairment losses due to credit losses. As a result, Generic Bank would be bound by the new ASU 326-30 to account for those additional impairments by adjusting an allowance for credit loss account. After further analysis of those accounts it is likely that some would be deemed uncollectable and thus written off because the bank cannot or would not have the continued desire to hold the security. Essentially, I think that in Heather Herrings role the answer would encompass the totality of the banks position not just regarding the CFO's plan for immediate sales.

A bank regulator may have a greater interest in Generic Banks estimation methods for their allowance accounts. The FDIC explains that the "alignment of allowance estimation practices with existing credit risk assessment and risk management practices is likely, as the new accounting standard allows a financial institution to leverage its current internal credit risk systems as a framework for estimating expected credit losses" (Accounting and Auditing: Current Expected Credit Losses). Most likely a regulator would also examine and verify the validity of the banks fair value estimates. At the end of the day, it sounds like Generic Bank is well capitalized and an established multi-state institution so it is unlikely that significant regulatory issues could have snuck through the cracks up to the current day.

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

If Generic Bank had sold their AFS securities at a gain then the bank would improve their overall financial position and they would likely not be in any hurry to sell the securities. In the case of a net gain the bank would probably want to reconsider all of the securities that they are intending to sell because a majority of them are in a positive position and could eventually return a higher value than at the current AFS price. They could sell the securities that are in a negative position as impairments, each of the net losses would be attributed to the allowance for debit loss. My reasoning derives from my answer Requirement #2 in which I also stated that I do not believe that the securities in positive positions (those where fair value exceeds amortized cost) should not be treated as impairments in Generic Banks reporting.

If the securities were all sold at gains I do not think the bank should move forward with selling at all, certainly not at an impairment. The bank could certainly still sell the securities because they are available for sale; they may choose to do this to improve liquidity ratios or for future acquisitions. The company would recognize some form of gain, based upon their reporting standards, that would transition to some form of more-liquid asset. The banks main line of business is in investing so these types of gains are normal business transactions that ultimately fund the entire network of Generic Banks across the six states. Recognition of an impairment loss would likely be troubling for investors; in this scenario the bank should reflect a positive financial effect.

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.

6. **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?**

There is an interesting portion of the ASU which explains how "the amendments in this Update are an improvement because they eliminate the probable initial recognition threshold in current GAAP and, instead, reflect an entity's current estimate of all expected credit losses" (Financial Instruments—Credit Losses, ASU 326-30). Now that Generic Bank is only adequately capitalized it is much more important that they are reporting their risky securities because their bottom line is much closer. The company would likely impair other losses in this scenario because they need more liquidity and minimizing risky securities may prove more financially beneficially than sacrificing securities with a high potential for growth. Joshua Winters should work closely with Heather Herring to analyze what the banks total impairment is and find ways to accurately estimate that in future periods as an allowance for debt losses.

7. **What I Learned**

This case study taught me about one entirely new concept and greatly enhanced my knowledge of another. I had heard the word securities thrown around a lot in Principles of Accounting; I had ascertained that it was a form of investment asset and was pretty sure that it had to do with bonds. After completing this case I have a firm understanding of what a security is and how a financial institution like a bank reconciles with the fluctuation in their values. I now also have insight into a very relevant and recent ASU that is going to dramatically shift the scope of work for certain accountants and bankers who deal regularly with AFS securities. The case offered a clear perspective into what roles such as bank regulators, auditors and CFOs. I find it interesting how the three operate on somewhat different time lines: auditors tend to work in the past, regulators are proactive in the present making sure everything is monitored day to day, and CFO's have to plan the long-term strategy and make sure it can be obtained while adhering to all of the best accounting standard practices. The word impairment was new to me but I could quickly understand the purpose and advantages of using this technique in the banking environment. Banks, including Generic Bank, operating on risk and to take an in-depth look at how the accounting world assists (and restricts) the banking operation taught me how the two industries are linked.

Case Study 5

City Selection Case:
Comparing New York City and Denver

Population

New York City, NY	Denver, CO
Population: 8.623m (2017)	Population: 704,621
Area: 302.6 mi^2	Area:155 mi^2
Population Density: 27,000 people per square mile	Population density: 4,044 people per square mile

Denver is 534% less densely populated than New York City

Climate and Seasonal Fluctuations

New York City, NY	Denver, CO
Avg. July High 84 Avg. Jan Low 26	Avg. July High 88 Avg. Jan Low 19
Range: 58	Range: 71
Rainfall (in): 47 Snowfall (in): 25	Rainfall (in): 17 Snowfall (in): 62

Denver has 8.6% more Sunny Days than New York.

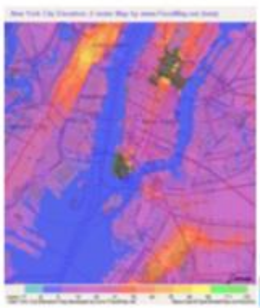
On the BestPlaces comfort index, New York (60/100) scores 16.7% worse than Denver (72/100)

Topography, scenery, other geological or geographical features, include pictures

New York City, NY

Elevation: 50

Bodies of Water



Denver, CO

Elevation: 5313, near Rocky Mountains

Water: 1.6 sq mi

Individual tax rate in the area (federal, state, local income tax, property tax)

<u>New York City, NY</u>

Sales Tax: 8.5%

NYC Avg. Property Tax: 0.8% (NY average is 1.6%)

NY State Income Tax: 6.85% (3425)

Local Tax: 3.628% (1,814)

Federal Tax: 16.415% (8,205)

What does that mean for a starting salary of $50,000:

$36,556

<u>Denver, CO</u>

Sales Tax: 7.65%

Denver Avg. Property Tax: 0.5% (CO average is 0.57%)

CO State Income Tax: 4.63% (2315)

Local Tax: none

Federal Tax: 16.415% (8,205)

What does that mean for a starting salary of $50,000:

$39,480

What transportation hubs are in the city

New York, NY

- Underground Rail: MTA and PATH
- Train Stations: Penn Station and Grand City Terminal
- Air: JFK (US #6 and Newark Liberty US #11)
- Bus: Port Authority Bus Terminal
- Ferry: Staten Island

Denver, CO

- Light Rail: FastTrack (9 rails, 18 miles of bus rapid transit, 95 stations)
- Train Station: Union Station Denver
- Air: DEN (US #5)

What is the city's most prevalent industries?

New York City, NY

1. Financial Services: 330,000 jobs = 90% of the total US industry
2. Health Care: 14.2% of population
3. **Professional and Technical Services: 647,800 jobs (accounting)**
4. Retail Trade: 800,000 jobs in 75,000 retail locations
5. Manufacturing: recovering with net gains since 2014
6. Educational Services: government is largest employer in the state of NY

Denver, CO

1. Aerospace: 54,300 private sector/military jobs #1 state for private aerospace employment concentration
2. Aviation: 15,690 workers directly employed by aviation companies
3. Bioscience: 5,610 biotechnology and pharmaceuticals workers and 9,480 workers in medical devices and instruments production.
4. Broadcasting and Telecommunications: 4th largest metro areas for broadcasting and telecommunications
5. Energy: Fossil fuel and clean technology companies employed more than 32,000.

Quality of City's Healthcare

New York City, NY	Denver, CO
Physicians per capita: 151	Physicians per capita: 368
Health care cost: 10% above US avg	Health care cost: 6.5% above US avg
#1 most improved state (2018), #18 in the US	#10 in the US (2017 & 2018)
Top 25% in: healthy lives, disparity	Top 25% in: avoidable hospital use and cost, healthy lives
Middle 50% in: access and affordability, prevention and treatment	Middle 50% in: access and affordability, prevention and treatment, disparity
Bottom 25% in: Avoidable hospital use and cost	

What crimes are common? Areas to avoid?

New York City, NY	Denver, CO
+Violent Crime: 585.8/100,000	Violent Crime: 673.9/100,000
+Murder 3.4/100,000	Murder 7.8/100,000
+Robbery/Burglary 263/100,000	Robbery/Burglary 878/100,000
+Property Crime 1,518.7/100,000	Property Crime 4,093.6/100,000
+Larceny/Theft 1,101.3/100,000	Larceny/Theft 2,192.5/100,000
+Vehicle Theft 89.4/100,000	Vehicle Theft 639.3/100,000
3 Dangerous Areas:	3 Dangerous Areas:
Vinegar Hill, Meatpacking District, Port Morris	Lincoln Park, Cheesman Park, Civic Center/Lower Downtown

How much rent do you expect to pay? Sample properties from each location. Describe square footage, amenities, roommates and parking

New York City, NY

On 3rd Avenue, East Village Manhattan

$2,200/month

1 bed 1 bath studio

Wifi, no kitchen (only fridge)

No public parking, rooftop view of Freedom Tower, shared/paid washer and dryer

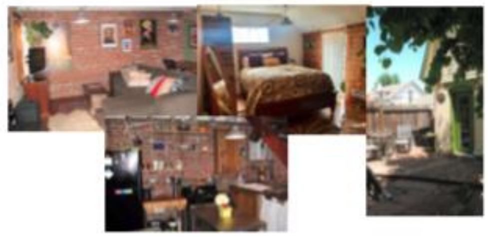
West Highlands

$1,621/month

1 bed 1 bath Carriage House

Wifi, Full kitchen, Courtyard

Free street parking, own washer and dryer



What is the typical mode of commuting? What is the average commute time?

New York City, NY

Commute time: 18 minute walk

Denver, CO

Commute Time: 12 minute drive

Where would you grocery shop?

Westside Market
Trader Joes
Union Market

Whole Foods
Safeway
Highlands Farmers Market

Name at least three civic, charitable or religious organizations you would be involved in if you were there?

New York City, NY

New York Restoration Project is a non-profit organization dedicated to transforming open space in under-resourced communities to create a greener, more sustainable New York City.

New York Cares has ongoing calendar listings for both short- and long-term volunteers to help public school children and teens with math, reading, and other classroom activities.

KEEN (kids enjoy exercise now), which volunteers to coach teams and help with fitness activities.

Denver, CO

The Park People works to preserve, enhance, and advocate for Denver's parks, recreation resources, open space and urban forest.

Denver VOICE's mission is to address the roots of homelessness by telling stories of poverty and homelessness and offering economic, educational and empowerment opportunities

Amp the Cause improves lives through entertainment, annual events and community service. They raise critical health and education funds, generate awareness for charities, use donations to help children with life-threatening illnesses, and provide opportunities for kids to participate in educational programs in a safe and healthy environment.

What sports, entertainment or recreational activities would you partake in? name at least 5 activities

New York City, NY

Radio City Music Hall
Madison Square Garden
Broadway
5th Avenue Shopping
Central Park
Yankee Stadium

Denver, CO

Red Rocks and Amphitheater
Union Station Dining and Shopping
Larimer Square
Coors/Sports Authority Fields
Rocky Mountain National Park
Winter Park (1 hr away)

What are the modes of travelling back to your hometown from the city, how much would it cost?

New York City, NY	Denver, CO
Fly home: $210 to KC, $220 back to NY	Fly: $120 to KC, $110 to DEN
Total: $430	Total: $230
Trip Time: 3 hr 15 min each way	Trip Time: 2 hr each way
Fly really home (Oxford): $220 to Memphis, $230 to JFK	Fly really home (Oxford): $150 to Memphis, $160 to Denver
Total: $450	Total: $310
Trip Time: 4hr 15min each way	Trip Time: 2 hr 15 min each way

Develop a model monthly operating budget for each city for Year 2 assuming your salary increases to 60,000

New York City, NY	Denver, CO
Salary 60,000	Salary 60,000
Less Tax: $43,864.20	Less Tax: $47,373
Monthly: $5,000	Monthly salary: $5,000
Less Tax: (1,344.65)	Less Tax (1,052.25)
NET of tax: 3,655.35	NET of tax: 3,947.75
Less Rent- includes utilities and accomodations: ($2,200)	Less Rent (includes utilities and accomodations): ($1,621)
Living $: 1,455.35	Living $: 2,326.75
About $48.52 a day	About $77.55 a day

Finally, based on the full analysis decide if you still want to live in each city and if so which one you would prefer, why?

New York City, NY	Standard	Denver, CO
-	Population	+
=	Climate	=
-	Topography	+
-	Taxes	+
=	Transportation	=
+	Industries	-
-	Healthcare	+
+	Crime	-
-	Rent	+

Finally, based on the full analysis decide if you still want to live in each city and if so which one you would prefer, why?

New York City, NY	Standard	Denver, CO
=	Commute	=
-	Grocery Shopping	+
-	Laundry	+
=	Civic Organizations	=
+	Entertainment	-
-	Travel Home	+
-	Monthly Budget	+
3	Total Wins (4 ties)	9

Summary

It appears that the ideal living conditions for me align more with Denver than New York City. I really was pretty sure this would be the case going into my research; mind you, I left Kansas City to come to the quaint town of Oxford! The simplicity of life in a place where nature can be enjoyed and the sheer number of human interactions per day is a mere fraction of New York's lends itself to an inherently slower pace life in my opinion. I think that would be a more enjoyable scenario from a comfort standpoint.

But, I have also have never been someone who stays in my comfort zone. I have to constantly challenge myself: moving to Dallas, enrolling in my first Ole Miss honors class as a junior in high school. The path of most resistance is one that I just can't seem to stay away from. The immense opportunities that exist in New York City are undeniable. I know the exact question that I have to ask: is there more money on the table to account for the enormous cost of living disparity? But I'm not sure how to ask that without coming off as brash.

What I learned

The most important thing that I learned is that even beyond the boundaries of this case I need to think much harder about where I want to begin my career. I had not considered how much life will change for me once I am outside of the bubble of heaven that is, Oxford, MS. That is not necessarily a deterrent by any means, rather it is a challenge and challenges have to be taken head on; this case was a great start at doing that.

Case Study 6

WorldCom

1. **Executive Summary**

The WorldCom scandal was one of the largest accounting scandals in the United States history subsequently leading to one of the largest bankruptcies as well. This scandal alongside Enron and Tyco lead to the drafting and adoption of the Sarbanes-Oxley Act in 2002. This act is now a central tenant for private and public accountants because it simultaneously increased the disclosure requirements and the penalties for failing to adhere to them. High quality accounting became more essential given the higher stakes of this act but Sarbanes-Oxley was just the start, the fluid regulatory environment that still persists demands that public accountants stay in the know with each evolving standard and practice.

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

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

Asset- Probable future economic benefits obtained or controlled by a particular entity as a result of past transaction or events.

Expense- Outflows or other using up of assets or incurrences of liabilities during a period from delivering or producing goods, rendering services or carrying out other activities that constitute the entity's ongoing major or central operations.

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

If a cost is 1. Used up or has expired and 2. They have no future economic value which can be measured THEN the cost should be expensed.

If a cost is 1. Not expired and 2. They have future economic value THEN is should be capitalized or recorded as an asset.

3. 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.

If a company expenses the entire cost it is added to the income statement and subtracts from the revenue to equal the profit. The salaries for administrative support staff would be charged as a monthly expense because there is no way to determine the future economic value of that work, it must all be a period cost. If WorldCom expensed their line installations the full cost of the construction would hit on one year's balance sheet and may skew projections but in future periods the profitability would be higher than if they choose to capitalize it.

If a company capitalizes a cost it is going to be accounted for as a capital expenditure. It will be accounted for as an asset and depreciated over time to its salvage value but not for the entire up-front cost. A prepaid insurance policy that is purchased for 6 months at 6,000 would be first recorded at cost as an asset and capitalized at 1,000 per month as the benefit of the policy is actually used up. By capitalizing cost and using fixed line depreciation the balance sheet would show higher assets and the income statement would be gradually impacted instead of being hit by a large expense in one period.

4. **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.**

To report expenses for transmission lines in 2011 the entry would read:

Transmission expense	$14,739 m	
Cash or A/P		$14, 739 m

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

The error, or fraud, in the WorldCom scenario came when the CFO, CEO and Controller realized that they were not going to meet earning targets and did not have enough time to rework the numbers. To inflate the net income, the CFO directed David Meyers, the controller, to capitalize the transmission expenses as if they were a long-term asset instead of having the entire expense hit at one time. They offset the change with goodwill they had acquired in the acquisition of over 20 different subsidiary companies. The fact that the lines were constructed by third party contractors and were constructed with the managerial intention of supporting current customers this would not qualify as an asset or a long-term investment and as such, should not have been capitalized in the first place, especially not in an effort to boost sales earnings. Doing so would constitute a grave infraction on the principle of conservatism.

6. **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? ″ Analysis ″**

PPE 3,055,000,000

Transmission Expense 3,055,000,000

The line cost of 3.055 billion should appear in the PPE portion of the company's balance sheet. Since it is assigned on the balance sheet it will not show up on the Income Statement unless it is capitalized improperly, as was the case with WorldCom.

7. **In a sworn statement to the Securities and Exchange Commission, WorldCom revealed details of the improperly capitalized amounts (in millions) in 2001: $771 in the first quarter, $610 in the second quarter, $743 in the third quarter, and $931 in the fourth quarter. Assume that WorldCom planned to depreciate these capitalized costs over the midpoint of the range for transmission equipment as disclosed in note 1. Further assume that**

depreciation begins in the quarter that assets are acquired (or costs capitalized). Calculate the related depreciation expense for 2001. Prepare the journal entry to record this depreciation.

World Com made purchases at the beginning of each quarter so q1=4/4 q2=3/4 q3=2/4 q4= ¼ and they chose to use 22 years for the useful life.

Quarter 1: 771,000,000/22 X 4/4 =$35,045,055

Quarter 2: 610,000,000/22 X 3/4 = $20,795,454

Quarter 3: 743,000,000/22 X 2/4 = $16,886,363

Quarter 4: 931,000,000/22 X 1/4 = $10,579,545

Total Depreciation Expense: $83,306,418

The Entry to Record the Depreciation expense in 2001:

Depreciation Expense	83,306,418	
Accumulated Depreciation		83,306,418

8. **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?**

Income Before Taxes:	2,393,000,000
+ Depreciation Expense for the Year	+83,306,819

- Improperly Capitalized Transmission Expense

(3,055,000,000)

Loss before taxes (if restated)	(578,693,182)
Income Tax Benefit (LossX0.35)	202,542,614
Net Loss (if restated)	(376,150,568)

The numbers reworked properly show that there is a material loss that should have been reported. Since WorldCom acted fraudulently they illegally avoided recognizing these enormous operating losses in favor of reporting an inaccurate material gain.

Case Study 7

Starbucks Corporation:
Understanding Financial Statements

1. Executive Summary

Starbucks Corporation (SBUX) is the global leader in sales of high-quality coffee selling over four billion cups a year out of their 23,187 retail locations located across 64 countries. In addition to coffee, Starbucks sells handcrafted beverages and teas, fresh food items and branded products like cups and in-home brewing devices at their licensed retail locations, grocery stores and through national food service providers. As an international business, Starbucks has decided to report earnings in 4 geographic segments: the Americas, EMEA, CAP and a group called "All Other Segments" which includes channel development, Teavana, Seattle's Best Coffee, Evolution Fresh and its Digital Ventures. Each year Starbucks must produce mandatory financial statements to inform stakeholders of the company's performance and account positions. Along with the release of these statements Starbucks releases "Notes to Consolidated Financial Statements" which summarize their significant accounting policies and disclose acquisitions and divestures. This additional information allows for a greater depth of analysis in regard to financial statements; it accompanies the quantitative results with qualitative explanations that clarify and justify the methods used to produce their stated results. The summary of significant accounting policies explains that Starbucks' corporate operating expenses are not attributed to any of the four segments but instead reconciled against the total of all segments. Additionally, all highly liquid instruments with a maturity of less than 3 months are classified as cash and cash equivalents; all major bank disbursement accounts are funded on a daily basis as checks are presented for payment. These are classified as book overdrafts which become a current liability in accounts payable because the outstanding checks may be in excess of cash balances at certain banks. All investments both short and long term are classified as available for sale and consist of primarily investment grade debt securities. These AFS securities are accounted for at fair value meaning that unrealized holding gains and losses get recorded, net of tax, as a component of comprehensive income. Inventories are classified at lower of cost or market with inventory reserves used for slow moving products. PPE is recorded at cost less accumulated depreciation; depreciation is provided on a straight-line basis over the asset's useful life. For equipment this ranges from two to fifteen years and thirty to forty years for buildings. Repairs and maintenance are expensed when incurred but improvements that effect the long-term capacity or extend the useful life of an asset are capitalized. Goodwill is tested for impairment on an annual basis; when evaluating impairment, the company performs a qualitative assessment to determine if the fair value of the reporting agency is greater than its carrying value. If the carrying amount of goodwill is greater than the implied estimated fair value then the impairment charge is recorded to reduce the carrying value to the determined estimated fair value. The company's intangible assets are composed of trade names and trademarks. Like with goodwill, if the qualitative assessment determines that the carrying amount of the intangible exceeds the estimated fair value an impairment charge is recorded to reduce the carrying value to the fair value. In contrast to intangibles with indefinite lives those with definite lives, like patents and copyrights, are amortized over their useful lives and are tested for impairment when facts indicate that the carrying value may not be recoverable. Consolidated revenue is reported net of product sales to and royalty fees from accounted for under equity accounts. The revenue is also reported net of discounts, returns, allowances and sales incentives. Sales from company operated stores are recorded when payment is tendered at the point of sale net of tax liabilities. Revenues from the sales of products to licensed stores are recognized at the point of shipment depending on contract terms with shipping charges recognized as revenue and included as cost of sales on the statement of earnings. Royalty revenues based on reported sales are recognized on a monthly basis when earned. Revenues from stored value cards are recognized upon redemption or when likelihood of redemption is deemed to be remote; outstanding customer balances are reported as deferred revenue. Most of Starbucks' advertising cost as well as the cost incurred with the startup and promotion of new locations is expensed as they are incurred. Finally, the company disclosed an acquisition of equity method ownership in Spain, the sale of a joint venture project in Spain, the acquisition of a coffee farm in Costa Rica and the acquisition of Teavana. At the end of consolidated financial reports is a report of independent registered public accounting firm in which Deloitte confirms that in their opinion the statements fairly and accurately present, in all material respects, the financial position of Starbucks for the years applicable.

2. Case Requirements

A.) Starbucks is an international producer and retail seller of premium coffee products. The company purchases, roasts and sells coffee as well as tea and other specialty hand-crafted beverages, food items and consumer goods like cups and in-home brewing devices. Starbucks sells their products from their wholly owned retail locations, licensed franchise locations, in grocery stores and through national food service providers. Their revenues originated from sales in their branded retail locations and from sales of consumer-packaged goods online and in stores.

B.) For the purpose of external reporting, public companies usually prepare a balance sheet, income statement, statement of cash flows and statement of shareholder equity. Starbucks titles these accounts, respectively, as consolidated balance sheet, consolidated statement of earnings, consolidated statement of cash flows and consolidated statement of equity. The purpose of denoting these statements as being consolidated is to denote that they are the merged, and totaled, figures from all segments of the parent company and its subsidiaries. The summary of significant accounting policies describes that the consolidated reports are the sum of reported earnings from their 4 business segments: the Americas, EMEA, CAP and a group called “All Other Segments” which includes channel development, Teavana, Seattle's Best Coffee, Evolution Fresh and its Digital Ventures.

C.) Starbucks has a public float value of $1.2 billion which classifies it as a large accelerated filer. This classification means that they must quarterly financial statements with the SEC within 40 days of quarter-end and annual statements within 60 days of year-end. This is typical for most publicly traded corporations who should also expect to prepare and file five financial statements each year.

D.) Financial statements are prepared by Starbucks' accounting and finance department with oversight and final approval provided by the company's CFO and CEO. Internally, the financial statements are used by management to assess and forecast financial performance and as an aid in the decision-making process. Externally, financial statements are used by regulatory agencies like the SEC and IRS to verify and document authenticity and by shareholders like investors to determine and forecast their risk and expected return on investment in Starbucks.

E.) Starbucks' financials are audited by the public accounting firm Deloitte & Touche LLP. Deloitte wrote two "opinion letters" that state that to the best of their knowledge all of the information is presented fairly and with respect to Generally Accepted Accounting Principles in the US. The first letter describes the fact that Deloitte conducted its audit in accordance with standards of the *Public Company Accounting Oversight Board* and to be reasonably certain that all material presented is free of error. This letter speaks to the fact that amounts are accurate as well as that the accounting methods employed to return those results are allowable. The second letter speaks to the audit of internal controls in accordance with the *Internal Control- Integrated Framework.* Deloitte notes that they understand the internal control structure, assessed risk of material weaknesses and they tested and evaluated the design and of internal control based on that risk. The internal control assessment verifies that records are maintained accurately and fairly to reflect the transactions and disposition of assets, transactions are recorded in a way that allows statements to be prepared in accordance with GAAP and that receipts or expenditures are authorized by management or directors and that unauthorized expenditure of assets are prevented or at the very least detected in a timely manner. The opinions are dated after the year-end because it takes a few months after Starbuck Corporation files the statements to thoroughly audit and verify the accuracy of the reporting.

F.)

	Common-Size Balance Sheet In Millions, unless otherwise specified	
	Sep. 29, 2013	Sep. 30, 2012
Current assets:		
Cash and cash equivalents	22.36%	14.46%
Short-term investments	5.71%	10.32%
Accounts receivable, net	4.87%	5.91%
Inventories	9.65%	15.10%
Prepaid expenses and other current assets	2.50%	2.39%
Deferred income taxes, net	2.41%	2.90%
Total current assets	*47.51%*	*51.09%*
Long-term investments	0.51%	1.41%
Equity and cost investments	4.31%	5.60%
Property, plant and equipment, net	27.79%	32.35%
Deferred income taxes, net	8.40%	1.18%
Other assets	1.61%	1.76%
Other intangible assets	2.39%	1.75%
Goodwill	7.49%	4.86%
TOTAL ASSETS	*100.00%*	*100.00%*
Current liabilities:		

Accounts payable		4.27%		4.84%
Accrued litigation charge		24.17%		0.00%
Accrued liabilities		11.02%		13.79%
Insurance reserves		1.55%		2.04%
Deferred revenue		5.68%		6.21%
Total current liabilities	*46.69%*		*26.89%*	
Long-term debt		11.28%		6.69%
Other long-term liabilities		3.11%		4.20%
TOTAL LIABILITIES	*61.08%*		*37.77%*	
Shareholders' equity:				
Common stock ($0.001 par value) - authorized, 1,200.0 shares; issued and outstanding, 753.2 and 749.3 shares (includes 3.4 common stock units), respectively		0.01%		0.01%
Additional paid-in capital		2.45%		0.48%
Retained earnings		35.86%		61.40%
Accumulated other comprehensive income		0.58%		0.28%
Total shareholders' equity		38.90%		62.16%
Noncontrolling interests		0.02%		0.07%
TOTAL EQUITY	*38.92%*		*62.23%*	
TOTAL LIABILITIES AND EQUITY	*100.00%*		*100.00%*	

	Common-Size Income Statement In Millions, except Per Share data, unless otherwise specified	
Net revenues:	**Sep. 29, 2013**	**Sep. 30, 2012**
Company-operated stores	79.190%	79.210%
Licensed stores	9.136%	9.100%
CPG, foodservice and other	11.674%	11.690%
Total net revenues	*100.000%*	*100.000%*
Cost of sales including occupancy costs	42.857%	43.711%
Store operating expenses	28.781%	29.461%
Other operating expenses	3.070%	3.232%
Depreciation and amortization expenses	4.173%	4.138%
General and administrative expenses	6.298%	6.024%
Litigation charge	18.695%	0.000%
Total operating expenses	*103.873%*	*86.566%*
Gain on sale of properties	0.000%	0.000%
Income from equity investees	1.688%	1.584%
Operating income	-2.185%	15.019%
Interest income and other, net	0.830%	0.710%
Interest expense	-0.189%	-0.246%
Earnings before income taxes	-1.544%	15.483%
Income taxes	-1.603%	5.071%
Net earnings including noncontrolling interests	*0.059%*	*10.412%*
Net earnings attributable to noncontrolling interest	*0.003%*	*0.007%*

Net earnings attributable to Starbucks	*0.056%*	*10.405%*
Earnings per share - basic	$0.01	$1.83
Earnings per share - diluted	$0.01	$1.79
Weighted average shares outstanding:		
Basic	5.031%	5.672%
Diluted	5.119%	5.812%
Cash dividends declared per share	$0.89	$0.72

G.) The accounting equation holds true for Starbucks because total assets (11,516.70) is the sum total of total liabilities (7,034.40) plus total equity (4,480.20). It is also reflected in the fact that on the common-size balance sheet the total liabilities and equity section is 100% in proportion to total assets.

Based on the balance sheet, Starbucks major assets are property, plant and equipment, net, cash and cash equivalents, and inventories. Property, plant, and equipment, net had a balance at the end of 2013 of $3,200,500,000 which represented 27.79% of total assets and a whopping 52.94% of all non-current assets. This seems appropriate for a company like Starbucks because they operate out of many retail locations, produce many consumable goods and their business relies on high-grade commercial cooking equipment. Cash and cash equivalencies increased from 14.46% of total assets in 2012 to 22.36% in 2013. This value seems appropriate given the cash-based nature of the retail sales business but particularly the 2013 value seems a bit high; Starbucks may want to pursue reinvestment options so they are not carrying such a large cash balance unless they are planning to take on a project that requires high liquidity. The inventories balance represented 9.65% of total assets or 20.31% of current assets in 2013, roughly $1,111,200,000. This seems appropriate given that Starbucks central business operations involve high turnover of inventory from the transfer and selling of goods in their company owned stores and to their licensed franchises. Short-term assets account for 47.51% of total assets with long-term assets accounting for the remaining 52.49%. The current ratio for 2013 is thus calculated as current assets (5,471.40) divided by current liabilities (5337.30) for a result of 1.03. This result is appropriate because it means that Starbucks has enough capital on hand to meet short term obligations if they were all due at once; in the event of liquidation the company would have more than enough liquid resources to relieve all of their current debt obligations.

An intangible asset is a long-term asset that are not physical in nature; it may only be conceptual but can still add value to the company. Examples include goodwill, intellectual property including patents and trademarks, and brand recognition. Goodwill is an intangible asset that is acquired when a company purchases another company or subsidiary and inherits a lower value of tangible goods than they pay; in this case the premium on the purchase is assumed to be goodwill. Starbucks has a high level of intangible assets composed of inherited goodwill, the trademarks at their licensed franchise locations and from the power of their tradename. The value of a company's brand, their loyal customer base and relationship, employee morale and intellectual property represent goodwill that may be purchased. Starbucks has a tremendous amount of goodwill from their brand recognition as a company and in their product names such the roast names of the whole coffee beans they sell. They have also benefited from creative strategic marketing techniques like their advertising initiatives and mobile apps that breed customer loyalty. As the market leader they also possess invaluable troves of data on consumer preferences and buying patterns that help them to research and develop new profitable business endeavors.

Starbucks has high operational expenses and these must be financed by some combination of internal and external sources. Typically, the liabilities on the balance sheet represent the capital that has been raised and is still outstanding from debt holders while the equity portion shows the funds that have been raised from shareholders. A tool often used to determine how much debt a company is using to finance its operation and assets relative to the value of equity is the debt to equity ratio. In 2013 total liabilities amounted to $7,034.40 million and dividing that amount by the equity balance of $4,482.30 million tells us that the balance of debt is 1.57 times as high as the balance of equity; this indicates that Starbucks prefers to finance their assets with liabilities to debt holders as opposed to shareholders. To highlight this fact, we can show that the $7,034.40 balance of liabilities to non-owners provided 61.08% of the capital required for total assets while the equity balance of $4482.30 shows that shareholders provide 38.92% of the financing.

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. Starbucks integrates both the cash-basis and accrual basis for different types of income recognition. In their company owned stores the revenues are recognized immediately upon collection at the point of sale. By contrast, for sales of tea, coffee, or other products to licensed stores the revenues are recognized when the shipment is released for shipping from the company to the licensee or in other timing terms as specified by the terms of the contract and the shipping charges are recognized as revenue and then included as cost of sales on the statement of earnings. For consumer-packaged-goods, food services, and other revenues, the revenue is recognized on a cash basis meaning that revenues are recorded when products are purchased by a customer. Stored value cards, like gift cards, are recognized as revenue when they are redeemed in store for a purchase or when the company determines that the likelihood of redemption is low based on historical experience. Since gift cards have no expiration date the revenue may be pending for a long period of time until it is deemed unlikely for redemption in which case the company terminates them and records the balance as revenue on the statement of earnings. A challenge is presented by the fact that unredeemed balances are recorded as unearned revenues, this amount totaled $33.0 million for year ending September 29, 2013. Since management is tasked with judging when to write off the unredeemed balances this could cause revenue (both earned and unearned) to fluctuate based on changing standards. Due to the nature of selling fresh products that have a limited shelf life there will regularly be losses that must offset revenues in order to account for unsold inventory.

ii. The statement of earnings reflect that Starbucks' major expenses are from the cost of sales designated as the cost of sales including occupancy cost and store operating expenses which averaged, respectively, 43% and 29% of net revenues in 2012 and 2013. These represent expected and forecastable expenses that will remain fairly consistent year to year as long as the company's business model remains the same. By contrast, in 2013 the earnings statement highlights a litigation charge that accounted for 18.7% of revenues, which is a notable amount. This likely implies that in the year 2013 Starbucks lost or deemed that they were likely to lose a court case with significant cost, this type of expense is irregular and not able to be forecasted because it is based on the external environment.

iii. At first glance it is apparent that from 2012 to 2013 the company's net revenues increased $1.6 billion. However, this increased in revenue was accompanied by nearly proportional increases in expenses; this can be clearly seen on the common-size balance sheet where all expense accounts represent nearly the same percentage of net revenues. For example, the cost of sales including occupancy tax increased from $5,813.30 million in 2012 to $6,382.20 million in 2013 but the proportion relative to revenues stayed fairly consistent at 43.7% and 42.9%, respectively. The only suggestion of a change in cost structure was the 2013 litigation charge which led to a near elimination of profits.

iv. International Accounting Standards mandate that irregular or unusual items like the 2013 litigation charge must be disclosed on financial statements and in a note disclosure discussing the nature of the event and the likelihood that it will have to be paid. The litigation charge is classified as an operating expense because the expense must be allocated to the year that it was incurred and it is not an ordinary transaction that can be classified as an investing or finance activity.

v. The statement of earnings can be used to conduct ratio analysis to determine Starbucks' profitability in the current period and in relation to prior periods; companies typically use profit margin, return on assets and return on equity to do this. The profit margin presents Net Income as a proportion of Net Revenues. In 2012 Net Income of $1,383.80 divided by Net Revenues of $13,299.50 indicate a profit margin of 10.4%; in 2013 Net Income of $8.30 divided by Net Revenues of $14,892 indicate a profit margin of 0.06%. The Return on Assets in 2012 was (1383.3/7789.8) or 17.76% and in 2013 was (8.3/9867.95) or 0.08%. The Return on Equity in 2012 was (1383.8/4749.7) or 29.1% and in 2013 was (8.3/4798.4) or 0.17%. For a retailer, the 2012 ratios all indicates a highly profitable business with great turnover on assets and equity, even given the substantial and unusual litigation charge in 2013 Starbucks still turned a profit.

I.)

i. Net earnings are the profits that Starbucks earned in the period while cash flow from operating activities measures the cash spent and received during day to day operations. Net earnings are the starting point of calculating cash flow from operating activities and is calculated by subtracting cost of sales, operational expenses, depreciation, amortization, interest and taxes from total revenues. Cash flow from operations is prepared for the statement of cash flows to measure a company's ability to manage its cash position by generating capital to pay off liabilities and pay for operations. Increases in assets such as deferred revenue is considered a use of cash while reduction of deferred revenue would be a source of cash. Decreases in deferred taxes are considered uses of cash and increases in deferred taxes are considered sources of cash. We can see that the net earnings in 2013 were $8,800,000 but the operating income is -$325,400,000. This difference is achieved because the net earnings are being shown net of the deferred tax balance which was substantial in 2013 to offset the cost incurred by the litigation charge.

ii. The Statement of Cash Flow show that in 2013 Starbucks spent $1,151.2 million for expenditures for property plant and equipment. This represents a 34% from 2012 which seems substantial but from 2011 to 2012 these expenditures increased 61%; the comparison shows that while expenditures did increase in 2013 they increased at a slower rate than they had previously.

iii. In 2013 Starbucks declared a cash dividend of $668.6 million and paid a cash dividend of $628.9 million. The difference of $39.7 million represent accrued dividends that are now a liability to the company.

J.) Starbucks management must make estimates and use assumptions that affect reported amounts of assets, liabilities, revenues and expenses. Examples of these are estimate for assets and goodwill impairment, stock-based compensation forfeiture rates, future asset retirement obligations and inventory reserves. Assumptions are made about self-insurance reserves, income on unredeemed gift cards, and the potential tax consequences of events that are recognized on the financial statement. However, certain accounts such as cash and cash equivalents, investments, marketing/advertising, leases and earnings per share should be able to be accounted for without the use of estimates because they have stated values and are not capitalized.

What I learned

My favorite take-away from this case is the construction and application of a common-size balance sheet; it proves useful in determining the significance of line item balances within a single period and for comparing them over time despite changes in revenue levels. What may appear at face value to be a dramatic increase in an expense or revenue may actually be expected given a similarly sized increase in total assets. I was also surprised by how simple the process of constructing these versions of statements was after downloading 10-K forms on the SEC.gov website and using a few simple excel techniques. I also learned how much information a company provides on their filings beyond just the quantitative data that appears on the statements. Starbucks also disclosed information about their accounting methods and revenue recognition principles that justify that the data provided is not only accurate but that it was derived from processes within the standards of GAAP. I found it read and interpret the “opinion letters” provided by the auditors because they offered insight into what my work would look like on a day-to-day basis as an auditor in a public accounting firm. The responsibility to verify the numbers and the methods to acquire the numbers sounds like engaging investigative work in my opinion. Ultimately this case required me, for the first time, to consider the totality of a large company’s financial reports and derive meaning from each individual statement as well as extrapolate meaning from the connectivity of multiple statements.

Case Study 8

BP:
Accounting Implications from Contingent Liabilities

1. Executive Summary

On April 20, 2010 the Deepwater Horizon oil rig exploded in the Gulf of Mexico, killing eleven and spilling millions of gallons of oil out into the ocean. The well was damaged in the explosion and continued to release oil into the Gulf for eighty-seven days until the well was successfully cemented shut. By the time the well was plugged it is estimated that 4.9 million barrels of oil contaminated the coast. BP was found ultimately responsible for the explosion and damages that followed along with an accompanying portion of blame cast on Transocean and Haliburton. While history has seen many oil spills of larger magnitudes the BP oil spill caused a disproportionately large portion of economic damages because it occurred in the midst of a densely populated region. The stakeholders that were impacted were widespread, diverse in size and nature and constantly evolving. The explosion resulted in the deaths of eleven of the rigs one hundred and twenty-six crew members, killed massive swaths of wildlife and set off massive chemical imbalances in the ocean, sidelined the fishing industry and drove tourists and families from the coast as the ocean suddenly became undesirable.

2. Requirements

A.) A contingent liability is a potential loss that a company could incur in the future after some uncertain event is resolved. A contingent liability should be recorded on the company's books if they believe that it is more likely that not that the event will occur and they can estimate the amount. In the event that a contingent liability exists but it is only reasonably possible that it will be incurred or if the event is probable but not estimable the company may choose to disclose the fact in a footnote; if the probability of occurring is remote it is not reported at all. Examples of contingent liabilities include outcomes of legal cases such as a lawsuit, government investigations which may levy fines, threats of loss from expropriation and product warranties. All of these examples have uncertain outcomes or degrees of outcomes. A company is not allowed to record a contingent asset even if they believe that it is probable that they will win a lawsuit and receive a settlement, for example.

B.) From the perspective of the seller, when GE Oil and Gas sells a product under warranty they must record an entry that represents a potential loss equivalent to the amount of the warranty to guarantee the quality of their product and ensure they remain operational for an assured period of time. On the balance sheets of GE Oil and Gas they would record a liability for a warranty payable in the amount that they estimate will be claimed. If no warranty claims are made by BP then GE would adjust their payable account to reverse out the expense. In BP's case they are purchasing the product and the warranty protects them from financial loss that they would otherwise incur if the product failed. They do not record an asset for this warranty however, that would be a contingent gain. At the point that BP makes a claim against the warranty the cost of repair would be recorded on GE Oil and Gas' accounts but no entry is required for BP because the full cost of the equipment and warranty is capitalized at purchase.

C.) Management needs to judge the likelihood of the loss scenario actually occurring in order to accounting for the liability. In the event of a warranty the managers would estimate the likelihood of warranties being redeemed, possibly based on historical data, and record that cost by debiting an expense and crediting a warranties payable liability. When a warranty cost is actually incurred the company would debit the accrued payable liability and credit the asset account used to fulfill the warranty obligation, whether that was cash, parts, or labor. Management must also estimate the magnitude of loss that will be incurred by each potential situation. The key difference from a traditional warranty claim and the damages resulting from the oil spill are that warranty claims are expected and routine while the oil spill was unforeseen and its impacts were unique. With the GE telescopic joint the number of potential claims is limited to specifically the customers they have sold their product to and the cost to repair was known because GE manufactured the parts themselves. By contrast, with the Deepwater Horizon spill the impacts and complainants were nearly infinite in possibility and the cost of the damages were largely a subject of opinion and most could not be remedied directly by BP.

D.) The managers and accountants for BP must make many estimates to account for the wide span of contingent liabilities that may arise from claims against the company for their role in causing, or failing to prevent the Deepwater Horizon spill. There are a number of potential fines from regulatory governmental bodies such as the EPA that seek to provide direct support to Gulf Coast residents to recover and rebuild and also to punish the company and make a point to other similar companies to prevent similar situations in the future. There may also be state level suits from Gulf States like Louisiana, Mississippi, Alabama, Texas and Florida. Many private complainants including business owners on the coast that rely on tourism, fishers and companies which rely on water sources from the coast are likely to join a class action lawsuit under the notion that they suffered a current or potential future loss of business as a response to the spill; that claim is contingent upon BP being found responsible for the disaster. Most directly, BP will face liabilities for the deaths of the eleven people onboard brought by their families for lost wages and punitive damage. The contamination of water sources and ground pollution may have resulted in illnesses for people and certainly harmed marine wildlife, which BP now has a responsibility to remedy and reverse. There may also be claims made by actors in the oil industry that were expecting BP to fulfill orders from the Deepwater Horizon well. In total, BP ended up estimating $37.2 billion for spill-related expenses; for context BP's 2018 net income was only $9.58 billion.

D2.) BP was able to set boundaries around the impact and size of the suit by establishing a limited number of damage categories which complainants could file towards for damages. BP limited some categories to specific degrees by only allowing, for example, commercial fisherman, seafood crew, or seafood vessel owners to claim damages under the seafood compensation program. By contrast, they left some open for interpretation like the economic damage category which only had an eligibility requirement that a natural person or entity had a loss of income, earnings or profits. The estimated accruals for specific groups like seafood compensation can be verified by typical audit procedures: calculating the value lost per unit based upon the area affected by the spill. The area of the spill would have to be estimated by marine experts using water tests or by employing drones to create technical models. BP also had to factor in the division of responsibility, while they were found to be the primary responsible party there was also blame cast on Transocean, who owned and staffed the rig, and Haliburton who was supposed to cement the hole and failed to do so. GAAP demands that the estimated values must be “fair and reasonable” to avoid misleading investors, lenders and regulators. The auditor would likely feel compelled to overestimate the contingency and adjust later rather than underestimating the impact and being non-compliant with GAAP.

3. What I Learned

This case made me consider how a company would account for a wide range of possible scenarios that stem from a certain event that has already happened. BP’s management and the auditors on their account were likely at odds as management aimed to reduce liabilities and estimates as much as possible but the auditors aimed to protect the integrity and accuracy of damages by doing a thorough assessment of risks and impacts. BP had to account for the incurrence of the full contingent liability in the period that the oil spill occurred in to correspond with GAAP, the costs were then incurred against the liability as they were realized and paid out but the legal expense itself was offset against the 2010 income. There were likely adjustments that had to be made in later periods as further expenses became known or became reasonably likely to occur. While economic claims against businesses were, to a reasonable degree, honored and paid out many of the claims against the environment are in contention to this day, likely because there are not complainants that can levee a charge in court. The environment was likely the group most directly harmed by the spill but is the one that in the economic outset is least compensated. The company has to balance a regulatory requirement to acknowledge a truthful and fair degree of economic harm but also wants to defer or avoid as many claims as it can to support its bottom line. Some contingent liabilities are predictable and routine while some, like the Deepwater Horizon oil spill, are so random and their impacts so pervasive that accounting for their expected impact becomes imperative to the survival of the company found responsible.

Case Study 9

Equity Method Investments:
Analysis of the “TimWen” Joint Venture

1. Executive Summary

Companies have many different uses for and intentions regarding investments that they acquire and maintain. One-way companies may decide to invest their money is in debt investments like a bond that pays interest revenue. The accounting consideration regarding debt investments asks if the company intends to hold the security to its maturity date or sell it off before that time. The second way that companies invest their money, and the focus of this case study is in equity securities. An equity security represents a share of ownership in a company by purchasing stock. The accounting consideration in regards to equity investments is the degree of influence that the investor will exercise while the investment is owned. There are three ranges of influence from passive influence, zero to twenty percent stakes, significant influence, from twenty to fifty percent, and controlling interest, fifty to one hundred percent ownership. To understand a passive interest, consider when an individual purchase a stock. The individual does not have any ability to affect the outcome of the company and thus they record the value of their investment at the fair market value, or what they could sell it for at the moment. Any dividends they receive are extra revenue from the investment. In the case of a controlling interest, the investor becomes the majority stakeholder and possesses legal control of the company and thus the earnings of the company are accounted for on the income statement, not as an attribute of the investment. But when a company has the ability to affect the outcome of a company with influence but does not own more than half of the company, we use a method called the equity method which recognizes a substantive economic relationship between investor and investee to accurately report the value of the investment. The investor will share in a portion of the investees income that will affect the investments value in a positive direction and mirror the impact to retained earnings from dividends paid by reducing the investments value.

2. Concepts

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

A company may choose to embark on a joint venture if they hope to achieve a common goal with a partner to reach a common consumer market; the two companies enter into a contractual agreement to work on a project for a set period of time. If a joint venture is successful the profits are shared based on the provisions of the contract; by contrast, losses would be realized equally in the same fashion. In this case Wendy's is likely entering into the joint venture in order to gain access to the Canadian market that Tim Hortons occupies but it may also be used to leverage human capital, technology or knowledge in a technical specialty. It may be cheaper for the investing company to invest in the joint venture than to develop the intangible on their own. The companies investing do not have to create a new business entity which allows for more flexibility than constructing a permanent business. A major benefit is that the risk associated with creating a new business unit is then shared proportionately by both joint venture investors.

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 for investments is the preferred method of accounting when an investor exercises significant influence in an investee's financial outcomes. This is generally considered to be an ownership stake between twenty and fifty percent; more than fifty percent is considered an ownership stake and warrants consolidation, ownership shares of less than twenty percent are accounted for using the traditional fair value method. The idea of significant influence is that the investor may gain representation on the board of directors and participate in the construction of management goals and strategies. An equity method investment is originally recorded on the balance sheet at cost of shares acquired and is adjusted based on the success of the company from its income and dividends. This is in contrast to the fair value method which adjusts the investment account to the fair value through an unrealized holding gain or loss that flows through income. When the investee earns money in a period, the investor records their proportional share of net earnings by increasing the investment's carrying value with a debit to the asset and the debit for the earnings recognition is to investment income. The opposite is true if the investee experiences a loss, the investment asset would be credited to decrease the carrying value and income would be debited to record a loss amount. The second aspect of the valuation effect in equity method accounting deals with the investor's receipt of dividends from the investee. The dividends received are in cash, which becomes the debit as always. In typical non-influencing investments, the cash received is recognized as dividend revenue but in the equity method the dividends decrease the carrying value of the equity investment asset. This is because the dividends paid come out of the investees retained earnings thus reducing the overall equity value of the company the investor has significant influence over.

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

When a company purchases shares in another company they may have to pay an amount in excess of the company's book value of equity, or net assets, divided by shares outstanding. This value is a premium for the purchase and traditionally it is believed that this value represents purchased goodwill. However, the equity method of accounting also requires a recognition of purchased assets at their fair value, which may exceed the value on the investee's books due to depreciation. For example, if a company acquired an investee for $1 million and the company's book value of net assets was $600 thousand the difference of $400 thousands is recognized as an acquisition accounting premium (AAP). The premium consists of two types of values: first, is we assume the fair value of the investee's assets is $800 thousand then there is a write up for the value of assets of $200 thousand that lives only on the investor's financial statements. This implies that the value of the premium attributable to fair value differences is depreciated and amortized exclusively by reducing the equity investment, it is not attributed to the asset itself. At this point the purchase is for $800 thousand of identifiable assets and the remaining $200 thousand difference to reach the acquisition price is accounted for per tradition as an intangible, goodwill. Goodwill is not amortized, rather, it is tested annually for impairment; valuation changes can only be downward and should never increase goodwill after purchase. If goodwill is impaired, a loss is recognized which is the only case in which goodwill would affect the investors net income.

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

In 2011, Wendy's includes $91,742 thousand for the equity investment attributable to their joint venture with THI in the notes to consolidated financial statements in the "assets" section under the title "investments" on the balance sheet. The equity investment section also includes $77 thousand for the joint venture with Japan. That means the total balance in the 2011 balance sheet for equity method investments should be the sum, or $91,819 thousand. In 2012 the joint venture with THI had a carrying value of $89,370 thousand and the joint venture with Japan has a loss carrying value of $1,750 meaning that the total amount included on the balance sheet for equity method investments should be $87,620 thousand. The loss from the Japan joint venture is also represented as an "other liability" because Wendy's has agreed to finance anticipated future cash requirements of the Japan JV and they share in a portion of the annual losses.

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

In 2012 the joint venture with Tim Hortons has a carrying value in equity investments of $89,370 thousand and the "Partner's Equity" reported in the TimWen portion of the consolidated balance sheet stands at $70,565 at the end of 2012. This is the equity for the entire joint venture meaning that Wendy's 50% stake has a value of $35,283 thousand. The difference of $54,087 is the acquisition accounting premium which includes the goodwill purchased and the writeup of Tim Horton's assets in Canada to fair value.

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

F (1). 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?

Because Wendy's has a controlling stake and used the equity method investment Wendy's has to account for their portion of TimWen earnings and the amortization of the purchase price premium adjustment which is recognized as a loss. This will decrease the total earnings before tax by $2,934 thousand in 2011 and $3,129 thousand in 2012. Dividends do not affect the earnings before tax because they do not flow through income, they exclusively change the valuation of the investment. The adjustments due to currency fluctuation also would not be included because it flows through comprehensive income. For 2012, the effect on earnings before taxes would be the value of the equity investment, $13,680 thousand, minus the loss on the investment due to the amortization of the purchase price adjustment, $3,129 thousand, for a total effect of $10,551 thousand. For 2011, the effect would be the value of the equity investment, $13,505 thousand, minus the loss on investment, $2,934 thousand, for a total income effect of $10,571 thousand. This appears on the income statement as an offset to operating expenses in the "cost and expenses" section under "Other operating expenses, net".

F (2). Prepare the journal entry to record Wendy's share of TimWen's 2012 earnings.

Wendy's share of TimWen's earnings in 2012 is listed at $13,680 thousand under the heading "Equity in earnings for the period" under the Note 8 breakdown of the consolidated income statement and balance sheets.

2012	Investment in Joint Venture- THI	13,680,000	
	Investment Income		13,680,000

F (3). What is the amount of the amortization of the purchase price adjustments in 2012? Prepare the journal entry to record the amortization of the purchase price adjustments for 2012.

The amount of the amortization of the purchase price adjustment in 2012 is 3,129. This is presented as "Amortization of purchase price adjustments" broken down in Note 8 of the income statement. The amortized premium decreases the value of the equity investment from the price that is paid to the book value on Tim Horton's balance sheet over a period of 21 years. The value in accounting using this method is that the premium on the purchase price is deducted from income as a loss over the expected aggregate life of the investment, not all at the time of purchase.

2012	Loss on Investment	3,129,000

Investment in Joint Venture 3,129,000

F (4). What number of dividends did Wendy's receive from the TimWen joint venture in 2012 and 2011? Prepare the journal entry to record the receipt of dividends from TimWen for 2012.

The value of dividends received from the TimWen JV in 2012 were $15,274 thousand and in 2011 were $14,942. These are represented as "Distributions received from TimWen joint venture" on the consolidated statement of cash flows. The cash from dividends is actual cash but the equity method of investment accounting requires that the investment account be decreased.

2011 Cash 14,942,000

Investment in Joint Venture 14,942,000

2012 Cash 15,274,000

Investment in Joint Venture 15,274,000

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

G (1). The operating activities section of the statement of cash flows reports a negative adjustment for "Equity in earnings in joint ventures, net" of $8,724 in 2012. Reconcile this amount to the information disclosed in Note 8. Explain why a negative adjustment is made to arrive at net cash from operating activities.

Since the F (i) shows that the equity method of accounting has a $10,551 thousand effect on net income but we know the value is from a non-cash transaction, the negative adjustment is made to subtract the amount from "net cash provided by operating activities" on the statement of cash flows. The adjustment is a decrease to operating income with an account called "equity in earnings in joint ventures, net" for a net amount of $8,724 thousand in 2012 because the $10,551 thousand increase is offset by the loss from the joint venture in Japan recorded as "equity in losses for the period" of $1,827 thousand.

> G (2). The operating section also reports a positive adjustment for "Distributions received from joint venture" of $15,274 in 2012. Reconcile this amount to the information disclosed in Note 8. Explain why a positive adjustment is made to arrive at net cash from operating activities.

The positive adjustment to "Cash flows from operating activities" is for $15,274 and represents the dividends received in the form of cash. The cash was not originally included in income because it adjusted the equity investment and thus did not flow through net income, so we must add it back to accurately represent cash on hand. This amount is the same value recorded in Note 8 as "distributions received" from the joint venture with Time Wen.

3. Conclusion

The most interesting application of the equity method that this case exhibited was the ability to identify the AAP by subtracting the share of TimWen's earnings from the carrying value of the equity investment. The fact that the premium on the purchase, $54,087 thousand, was one and a half times Wendy’s the annual share of the income shows that Wendy’s paid a substantial premium at the onset of the joint venture. However, the long-term nature of the venture means that they have a substantial period of time to recover the premium. I found the consolidation method on the balance sheets to be useful, the general financial statements accurately represent the total financial health of Wendy’s but the notes allow for a more detailed analysis of what is driving the total in areas where multiple factors impact a single line item. It is interesting that a company can have many joint ventures, some winners and some losers, and the effect on financial statements is a net amount; losses do not have to be reported independently which may reflect negatively on financial health. I also found the adjustments to cash flow statements to be intuitive and understand how necessary it is in the equity method because non-cash transactions impact the income statement but cannot flow through to the statement of cash flows.

Case Study 10

Retirement Obligations:
Johnson & Johnson

1. Executive Summary

In the Johnson & Johnson case study we looked at financial statements in pertinence to how they are impacted by pension plans. Nearly every large company offers a pension plan as a competitive employment benefit; a company could use their pension plan, and enticing matching programs to pull top talent to their company. A pension plan is funded and tied as a liability to a company but it is actually managed by an outside entity such as a bank. The company pays money, contributions, into the pension plan to meet the future obligations and the manager of the pension plan invests the money to produce a return. The company has varying levels of obligation based upon which type of pension plan they offer employees. In one scenario they could offer a defined benefit plan meaning that an employee is entitled to a percentage of their highest salary upon reaching a long enough tenure in the company; in the case of a defined contribution plan the company is only liable to match the contribution of an employee and the risk is borne by the employee. Once the money is invested in a defined contribution plan the value could rise or fall but the employee only receives the fair value of the invested assets at the point they retire. In the case of a defined benefit plan the employer must meet the promised amount regardless of if the assets perform well or poorly in the market. Since the company delegates the management of the pension plan to an external party, once the contributions are paid to the fund they are not liable for paying the benefits to retirees. This makes a defined contribution plan incredibly simple for a company because they only have the responsibility to match and then the rest of the retirement benefits process is automated. In a defined benefit plan the company must constantly monitor the performance of assets and make judgements to determine if they are on pace to meet the liability of current and past employees work.

2. Requirements

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

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

A defined benefit plan is a plan in which the employer contributes to the pension fund in an amount based on a formula, usually as a match to a percentage of the employee's salary. A defined benefit plan promises employees a percentage of their highest achieved salary upon retirement, usually once they have become a vested employee by working a sufficient number of years. Johnson and Johnson support both plans but the majority of their pension expense is to defined benefit plans.

ii. Explain why retirement plan obligations are liabilities.

The total amount of liability accumulated in the pension plan is called the projected benefit obligation, which the employer must pay once employees retire. The retirement plan obligation accrues based on work that the employee has performed so they are obligated to pay the benefits if the employees perform the work.

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

The company predicts the obligation they will eventually have to pay out based on actuarial assumptions. The actuaries make predictions of how long employees will live, how long they will work and the level of salary that they will achieve before retiring. These estimates are required to determine the level of benefits the company is on the hook for.

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 (to an intern for example).

The companies period expense is recorded as pension expense which is the combination of service costs, the interest accrued on the projected benefit obligation, actuarial gains or losses based on estimate changes and the amount of benefits that are actually paid to retired employees. Service cost is an expense for the work that employees performed in exchange for the retirement benefits. Interest cost is the interest that accrues on the outstanding pension liability, they are calculated based on a settlement rate. Actuarial gains and losses are changes in predictions about the assumptions discussed in (A.iii) such as mortality rates, employee tenures and future salaries. The benefits that are actually paid in a period reduce the liability but also decrease the plan assets.

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 accrued assets associated with pensions are stored in the pension asset memo record. The pension assets increase from actual returns, period contributions and benefits paid to retirees. The pension assets are managed by the pension company and invested to return a safe but respectable return. At the beginning of each year the company estimates how much return they expect on their plan assets. The plan assets will increase by the total actual return but the pension expense can only be reduced by the expected return, the unexpected gain or loss must be stored as other comprehensive income. The company pays in a certain amount each period to plan assets, this is called the contribution and it debits plan assets by crediting the companies cash account. The benefits paid deduct from the plan assets in order to pay off the pension liability, the PBO.

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

The company estimates their return based on the expected percentage of return the managing company projects to accrue on the plan assets. The return has two effects, it increases the plan assets but it also decreases the pension expense for each period. The plan assets increase by the actual amount of the return, even if that exceeds the expected return. By contrast, the pension expense can only decrease by the expected return. Any amount of return that exceeds the expected return is reversed by an unexpected gain or loss. An unexpected loss is stored as a debit to other comprehensive income- loss and thus results in a credit to pension expense, thus decreasing it. An unexpected gain is stored with a credit to other comprehensive income- gain and is reversed with a debit to pension expense, thus increasing it to net out the unexpected gain in excess of the expected return.

E. Consider Johnson & Johnson's pension expense detailed on page 61 of the company's annual report.

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

The company reported $646 million in pension expense for 2007 as "net periodic benefit cost".

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

Pension Expense $1,253,000,000

Projected Benefit Obligation $1,253,000,000

F. 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?

The company began the year with a projected benefit obligation of $11,660 million then based on the pension expenses less the benefits paid over the period the obligation increased to $12,002 million. This value is the current projected amount that Johnson and Johnson will be responsible to pay to their employees once they retire. It is only as reliable as the actuarial assumptions that were used to estimate it in the presence of future uncertainties about employee tenure and salaries.

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

The pension-related interest cost for the year is based on the beginning balance of the projected benefit obligation times the settlement rate. On the financial statements we can see that the 2007 interest cost was $656 million. The beginning projected benefit obligation was increased at the start of 2007 by an actuarial amendment that increased the projected benefit obligation by $14 million to a beginning balance of $11,674 million. The interest cost of $656 million/$11,674 million obligation equates to a settlement rate of 5.62%. This seems reasonable given that it is between the recorded international 5.5% rate and the domestic plan discount rate of 6.5%.

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

The amount recorded as benefits paid from plan are $481 million. The benefits were paid as a credit to plan assets and a debit to the projected benefit obligation. This means that the company did not directly pay cash for the benefits; rather the pension company paid cash from the plan assets that had been accrued from the contributions the company actually paid out in cash.

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

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

The value of Johnson and Johnson's retirement plan assets at the end of 2007 is $10,469 million. This amount is the fair value of the contributions that Johnson and Johnson has accrued and has available for paying out retirement plan benefits when employees retire and become entitled to them.

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 Johnson and Johnson expected a return on plan asset of $701 million and in 2007 they expected a return of $809 million that is recorded as "Expected return on plan assets". The actual return is recorded as "Actual return on plan assets" in an amount of $966 million in 2006 and $743 million in 2007. The difference between the 2007 amounts is an 8% loss which is not significant or outside of the corridor; however, the 2007 difference is a 27% unexpected gain which represents an unusually large amount. The best amount to reflect the economics of the pension expense is the expected return because the excess return that is unexpected must be stored in other comprehensive income and amortized if it is outside of the corridor.

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

In 2007, Johnson and Johnson contributed $317 million listed as "company contributions" and their employees contributed $62 million listed as "plan participant contributions". Both of these are increases from the 2006 contributions of $259 million from the company and $47 million from employees.

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

The US Retirement plan for Johnson and Johnson is composed of 79% equity securities and 21% of debt securities. Their international retirement plans are composed of 67% equity securities, 32% debt securities and 1% real estate and others.

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

The company has a total current liability recorded as “employee related obligations” with a balance of $5,402. Since this is a positive value it means that the plan is underfunded because the company has an obligation to compensate for the difference in the obligation and the plan assets.

Case Study 11

Balance Sheet Based Model of Financial Reporting

1. Executive Summary

The article "On the Balance Sheet-Based Model of Financial Reporting" is a critical analysis of the harms caused by a balance sheet orientation of accounting as opposed to the income-statement approach. The essential argument is that the income-statement approach to accounting provides a more accurate view of the business operation and view the determination of revenues, expenses and earnings as the primary goal of financial reporting rather than the valuation of assets and liabilities in the balance sheet approach. The four flaws of balance sheet orientation are outlined out as the failure to reflect business reality, that assets are a less useful benchmark than income, that earnings is the most important output of the accounting system and that feedback loops are created. It makes two suggestions of changes that must be made to mend the shortcomings: first, there must be a distinction between operating and financing assets on the financial statements and that there must be greater emphasis on matching of expenses to revenue. The writers believe that the income-statement approach is the most natural foundation for financial reporting for the majority of firms and failing to amend standards results in faulty accounting that is less useful to investors.

The balance-sheet orientation has been the dominant feature of financial reporting for the last 30 years. This orientation promotes the idea that the proper valuation of assets and liabilities is the primary goal of financial reporting and other variables are derivative. Thus, income statement amounts and earnings are governed by the balance sheet. In this scenario, the correct determination of assets and liabilities completely determines earnings; in other words, earnings is the change in net assets over the period.

The contrasting orientation is focused on the income statement and was prominent for much of history until the mid-1970's. It emphasizes the idea that determination of revenues, expenses and earnings is the primary goal of financial reporting by properly determining the timing and magnitude of revenues and expenses. In this view, the balance sheet accounts are derivatives of the income statement. This method is guided by the revenue recognition and matching principle to properly record the timing of revenue and the alignment of the associated expenses that produced it. This method is supported by investors and analysts who believe that a stock's value arises from the ability to generate future earnings.

The Financial Accounting Standards Board has distinguished between the two methods as distinct alternatives where one must be chosen over the other to avoid a muddling of standards. They concluded in the late 1970's that the balance sheet approach is the most logical and sound basis of accounting and demanded that it should be the cornerstone of standard-setting and reporting. The concluded this because of a conceptual supremacy and the notion that earnings are a "change in value" concept. To determine what "value" is assets and liabilities must be calculated prior to determining earnings. The contrasting notion is that the income statement approach which relies on vague concepts like matching and results in deferrals and accruals which have questionable substance. The adoption of "fair value" accounting further solidified the adoption of the balance sheet approach by making market prices the benchmark of value for company accounting. Balance sheet accounting has become the dominant world-wide accounting doctrine today. The Preliminary Views document strongly endorses a balance sheet model by not using terms like revenues, expenses, earnings and income in favor of variations of “changes in economic resources and claims on them”. At the same time the conceptual framework dose nod to the importance of earnings in financial reporting by saying that the primary focus of financial reporting is information about an enterprise’s performance provided by measures of income and its components. Standard setters view earnings as less important than benchmarks of value from balances of accounts.

The first of four indicts of the balance sheet approach is its misalignment with the typical business cycle in which companies advance expenses in order to earn revenue. This suggests that assets are temporary devices that support a company’s operation and have little independent value. The article argues that the balance sheet approach only makes sense if a company is an “asset greenhouse” which produces revenue simply by storing and growing assets. But, most companies are not greenhouses but “asset furnaces” which sacrifice their assets by transforming them into revenue. The balance sheet implies that assets are permanent stores of value when in fact the assets exist temporarily in the process of sacrifice. What really matters, the article argues, is how expenses are advanced and revenues are ultimately earned. The article notes that it is “putting the horse before the cart” if firms follow income statement logic but reporting follows balance sheet logic. Managers use the income statement approach when preparing budgets by forecasting revenues before predicting costs; only after budgeting do managers think about the assets needed to support their projections. Managers do not consider the value of an investment to come from the build-up of assets but rather the added value in terms of future cash flows. Investors are concerned primarily with income statement considerations as well by first projecting revenues and cost then checking balance sheets accounts and the free cash flow. The flaw in the balance sheet model is that it takes assets values as stores of value exclusive of what the firm uses them for rather than focusing on their larger role in the operation. The income statement model solves this problem but focusing on the operation and looks at assets not as a store of value itself but a store of potential value used up in the business process. The value of assets in the balance sheet model is from the value-in-exchange whereas the income statement model values them at the value-in-use which is aligned with operation. Most companies are processes not just collections of assets and thus the financial statement model is a better foundation. In general, a small portion of PPE is eventually sold thus the use of PPE internally exceeds external purposes by 5 to 10 times suggesting that only a small fraction of PPE is relevant to consider at market value, it is irrelevant for 98 to 99% of firm assets. Yet, fair value mark ups are prominent in balance sheet accounting and flow through the income statement making earnings more volatile. Accounting should focus on the internal uses of assets and less on external value fluctuations. The distinction in value is if assets are used for operating or financing activities; for the limited number of financing assets a balance sheet approach makes sense but in general it does not for operating assets with little independent value to a company.

Second, they take issue with the FASB considering earnings as a change in value because they define assets as “probable future economic benefits obtained or controlled by an entity as a result of past transactions or events”. This seems circular because the economic benefits are earnings thus the assets are actually defined in terms of expected earnings and assets are connected directly to income. The problem is that the balance sheet approach separates the two concepts and says the assets are superior to the earnings in terms of reporting value. Furthermore, intangible assets are difficult to operationalize in any way. The existence and valuation of intangible assets is a derivative of income, suggesting income statement should be used.

Third, the value of reporting to investors is the ability of the report to advise on how to buy earnings. Investors need to be able to predict recurring earnings instead of the change in assets. Market value accounting shows earnings that are pure noise with volatility and little predictability by creating earnings that are not useful to investors. This has increased the volatility of earnings due to changes in the economy not operational occurrences meaning that the relation of stock prices and earnings is weak. The erosion of the utility of reporting hurts the value of the accounting profession. This most harms unsophisticated investors who rely on GAAP metrics like price to earnings ratios to value investments. Only sophisticated investors can sift through financial information if earnings have no significant value which means there is not a level playing field in the financial market.

Finally, the mark to model approach allows for managerial input with potential for estimation errors and manipulation which are subject to error. Balance sheet accounting creates a feedback loop by putting faith in market prices which is dangerous when prices deviate from the fundamental value of the asset. There is a difference between the real economy where the company makes value and the financial market which makes a guess about the value of assets. Accounting must reflect the real economic activities and provide checks on the valuation process. If financial markets revalue assets up then the economic markets go up because firms show earnings from assets, which creates a self-propagating cycle.

The conclusion made is that there must be a distinction made between operating and financing activities. Operating activities and resources used have the primary purpose of supporting and enhancing firm activities meaning they have limited value as independent stores of value. By contrast financing activities revolve around cash and equivalent assets like marketable securities. Only operating activities have a forward looking informativeness while financing activities have little persistence and predictive power. Operating assets are essentially just a list of unexpired costs which will be realized internally, meaning there is little sense in using fair value to account. The cash flow should distinguish between cash generated from the company operations and from financing activities. Second, there should be a renewed emphasis on matching and less on revenue recognition. Using matching in accounting is logically because it shows the connection of costs and benefits that are present in business cycles. To faithfully reflect the business the reporting should reflect the assets as drivers of business and matching should be shown in the financial reporting system but the current standard ignores this concept.

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

The article made me realize that there may be downfalls in the methods of reporting that is considered standard and acceptable under GAAP. We learn GAAP principles as truth but I had never before considered them critically by thinking about how their outputs may skew the value of reporting. The accounting equation is taught as assets= liability – equity but rarely do I think about how that actually factors into the earnings reported. In intermediate accounting I have learned extensively about how assets are continually updated to reflect fair market values based on external market conditions. While these values are unrealized and flow through comprehensive income to the untrained eye, or an untrained investor the sense that earnings are being produced by changes in market value may cause them to invest in a company even though the change in value is not indicative of an actual ability of the company to produce earnings in the future. That is the main disconnect between the balance sheet and income statement approaches to accounting; the balance sheet method is a snapshot so its basis the value of the company on the value of its "things" at any point in time while the income statement approach basis the value on the projection of future earnings. It seems preferable to value an approach which lends itself to likely future benefits by matching income that is likely to arise from expenses that occur in periods.

I was most responsive to the section in the article that reflected on how the two methods impact the value of financial reporting because if reporting losses value so does the profession of accounting. If the balance sheet is used to make investment decisions but the earnings are based on non-recurring activities then a passive investor may make a poor investment decision based on the notion that they are using GAAP financials. At the same time, a skilled investor with many resources can run substantial analysis and breed much more purposeful data by using complex equations that actually reveal the future cash flows that will arise from the company. It is unfair that the passive investor is at a disadvantage by placing trust in the standard reporting and makes the financial markets much less appealing to unskilled investors, disincentivizing them from participating. Additionally, I had never considered the problem with valuation accounts feeding into earnings and how that may create an arbitrary cycle. If the financial market says that assets have appreciated in value then the company in turn appreciates in value which helps the financial markets in general. This is especially troubling because of the fact that most assets are not intended to be sold but rather are exclusively used in operations and depreciated as used. Since the asset is never going to be sold there is no reason that the company should increase its value on financial statements if that value is not going to be realized, it is still only going to correspond to the predetermined earnings value that was calculated in the pre-purchase budgeting consideration. The value of the asset is much more useful in terms of its connection to an expected benefit than what it could theoretically be sold at market for.

I now believe that in fact, the assets value should be derived from their potential for earnings not the earnings being derived from the assets potential value. In this way, the earnings and the value that investors base their financial decisions on is derived from the potential of revenue that may arise from the asset's existence rather than from its existence alone. Gains or losses which are ancillary to the actual operational benefits of the investee should be reflected in such a way that it is clear they are not likely to continue and so the value of the company to an investor is less directly linked to the rises and falls of the economy and managerial estimates of asset values.

3. How will you use this information in your future career?

I am going into the business tax practice specifically hoping to working the Accounting Methods and Credit Services department and I believe that the income statement approach lends itself much better to the notion of receiving credits for manufacturing and R&D expenditures. In the case of R&D expenditure it is necessary to match the expenses to the expected period of benefit by capitalizing the expense over the period of expected return. This allows for accounting to follow the economic cycle and logic of the business process itself. The managerial decision to invest in the R&D is based on matching costs to benefits and part of that benefit may include the value of a tax incentive produced. The full expense, and accordingly the full asset that is produced in development is not helpful to reporting if it is present on the balance sheet of the year of inception and not factored into the years of benefit. Rather, through the lense of the income statement it would be obvious that the benefit over the period it is received is the product of the earnings themselves minus the portion of the R&D expense used up in that time period. Simply looking at the balance sheet does not paint the picture of what is actually occurring in the company because it is only a snapshot of the current position; that position must be portrayed in context of the process that is occurring. Thus, the tax benefits derived from the expenditure should also be equally spread out over the period of revenue receipt.

Similarly, manufacturing assets are a large expenditure leading up to the beginning of a production cycle; the machines themselves have value but in terms of investor information that value does not suggest the company's health or operational profits, only the potential to do so. The benefits that come from production of goods in a period like section 199 tax credits should be offset against the depreciation of the assets in a proportional form to the goods that are being produced. For every good that is produced there is a benefit which should essentially increase the income and earnings that investors suppose will come from the company's ongoing production. Rather than increasing a tax asset, this should offset the asset account and theoretically decrease the manufacturing costs. The impact is the same, to increase net income but it does so by recognizing that there is an expected benefit to the asset rather than an external benefit to production. This better matches the benefits of production to the expense that would originally be incurred to start up the manufacturing line.

As an analyst or an investor potentially weighing the impacts of mergers and acquisitions I will be keen to make sure that assessments of value are based on ongoing operations rather than arbitrary assessments of value which are subject to periodic and inconsistent changes. Realizing that taxes are based on income, not on asset values leads me to believe that there is some inherent value in all potential investors narrowing in their perspective on the idea of revenues instead of account values. The values of assets and liabilities should be a derivative of income, not the other way around.

Case Study 12

Earnings Announcements and the Information Environment:
A Study of Google Inc.

1. Introduction

Nearly all of our undergraduate accounting education aims to instill GAAP principles and reporting standards; these formal and standardized techniques present a reporting environment where there is a consistent format for company's financial reports that can be interpreted and compared side-by-side with the knowledge that each line item was calculated in the same fashion. However, a one size fits all framework may not accommodate for the unique nature of our economy. Different types of businesses incur different types of expenses and GAAP financial standards that help one type of business may significant harm the financial reporting of another. For this reason, companies are allowed to present non-GAAP financial measures in their earnings reports to present financial data that they believe is better tailored to forecast their businesses ongoing strengths and weaknesses than GAAP reporting. Internally, management has the ability to report on business health as a whole or in defined segments however they please. They are not compelled to abide by GAAP to extract the analytics that they deem useful to their efforts to make decisions. Typically, the goal when presenting non-GAAP financial measures is to translate the GAAP measures into the measures that internal management uses to asses financial health. Ideally, this provides investors with an inside look at how the company is thriving absent regulatory frameworks; at worst, this allows management to alter results when they are negative to present the company in a negative light despite poor performance. There is certainly value in a company being able to present data that more accurately indicates future performance metrics but this must be accompanied by clear explanations of the adjustments that are made and how they refine the data to provide better insights to investors and other users of financial data. If calculated faithfully, non-GAAP financial metrics can provide passive investors with metrics at a glance that are typically only calculated by high level investors.

2. Requirements

a. Summary of "Non-GAAP Performance Measures: Virtue or Vice?"

A non-GAAP financial measure is a number representing a company's financial performance, position, or cash flows that excludes amounts included or excluded from the comparable GAAP measure. When one of these measures is disclosed, it must be accompanied by that most comparable GAAP measure and reconciled between the two amounts by showing the adjustments. Management must also describe their reasoning for the usefulness of the non-GAAP financial measure to investors and explain the purpose for use of the measure. GAAP prohibits the elimination or smoothing of non-recurring items where there has been a similar charge or credit within the prior two years because this indicates that the charge is likely to occur again within the ensuing two years. But, in terms of non-GAAP financial measures a company can make any adjustment that it deems appropriate as long as it is disclosed subject to Regulation G and Item 10(e). These non-GAAP financial measures have been around since the 1960's when they were called "pro forma earnings"; the Sarbanes-Oxley Act replaced this term with "non-GAAP financial measure". Non-GAAP financial measures can include earnings before interest and tax, earnings before interest, tax, depreciation and amortization, and adjusted EBITDA; a survey by PwC found that 60% of IPOS over the past three years included at least one of these non-GAAP measures. Companies present these measures because they believe they provide insight into the company's core operations better than the standardized format of GAAP reporting. They hope that the customized presentation provides investors with a view of the company through managements eyes to provide a better understating of the business.

Internationally, regulators have permitted companies the flexibility to present non-GAAP performance measures as they see fit. This allows operating results to provide users with managements perspective to assess to performance of individual segments and their resources. Companies present non-GAAP earnings in hopes of overturning negative GAAP results and to report positive earnings growth when growth is negative on the GAAP basis. There is evidence to support the notion that the quality of non-GAAP earnings quality has improved since the issuance of Regulation G requirements to reconcile non-GAAP metrics with comparable GAAP measures. Since non-GAAP measures exclude temporary items, they may be better predictors of future earnings and cash flows. One of the most frequent non-GAAP measures used is adjusted EBITDA. The most frequent items subtracted or added to net income to arrive at this measure are stock compensation, asset impairments and write-offs, M&A costs, restructuring costs, loss on debt extinguishments, changes in fair values of assets and liabilities and gains or losses on the sale of assets. While these are the most common, there are more than 30 different reconciling items that companies can adjust for; this provides management with high flexibility to arrive at its version of the company's core earnings. At the same time, it makes it difficult for regulators to establish rules about the selection of these items.

The high degree of variability allowed in a company's techniques to arrive at non-GAAP performance measures harms the comparability of company financial metrics. Investors agree that value could be enhanced if the adjustments were accompanied by explanations of the reconciling items and why each item was included or excluded from the metric. Since the goal of the measure should be to give the investor a view of how managers assess a segments performance, an explanation of managements use of the measure would help investors understand the operational segment. For this reason, the FASB is researching how to improve the relevance of information presented on the income statement by developing a framework to define operating activities which distinguishes between recurring and infrequent items. GAAP and non-GAAP metrics should complement each other to provide a useful analytical tool to understand the company's underlying business, not complicate the process of analyzing financial performance.

b. 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?

Typically, operating margins are presented as consolidated income from operations, in accordance with GAAP, divided by consolidated revenues. Google converts their GAAP measures to non-GAAP results with five adjustments including the elimination of stock-based compensation expense, the elimination of restructuring and related charges, the elimination of the income effects of both the compensation and restructuring expenses and the elimination of net losses from discontinued operations. By making these adjustments Google presents the Non-GAAP operating margin as the non-GAAP consolidated income from operations divided by consolidated revenues. The vast majority of the adjustment comes from eliminating stock-based compensation expense by adding it back in to consolidated income which in 2013 accounted for $902 million on top of $3,922 million of GAAP earnings.

I understand the intuition behind adding the expense back in, since it was technically non-cash the expense came in lieu of paying additional salaries; but, it also diluted the shares when issued so it did come at a cost to shareholders. Overall, I do not think that the adding back of stock based compensation is of value to the investor, it represents a cost of operations and thus it is best to view the operating income without it. Warren Buffet is on the record supporting my intuition saying, “The very name says it all: 'compensation.' If compensation isn't an expense, what is it? And, if real and recurring expenses don’t belong in the calculation of earnings, where in the world do they belong?” Upon external research I found that Google has taken note of this and made the following announcement in 2017: “Although it’s not a cash expense, we consider it to be a real cost of running our business because SBC is critical to our ability to attract and retain the best talent in the world. Starting with our first quarter results for 2017, we will no longer regularly exclude stock-based compensation expense from Non-GAAP results.” However, the charges related to restricting and the net loss from discontinued operations do seem like viable candidates for exclusion in non-GAAP reporting because they are non-recurring. It is valuable for an investor to see the results absent singularities such as Google’s sale of Motorola to make a prediction about what earnings could look like in future period absent these sectors.

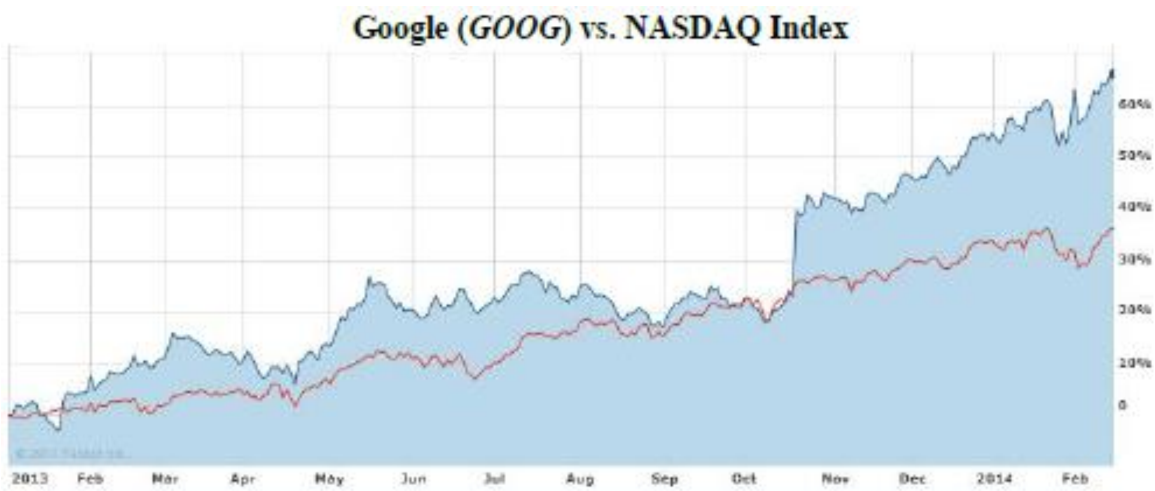
c. Compare Google’s fiscal 2013 earnings performance with the movement in Google’s stock price over 2013.

The best way to understand the relationship of stock price and earnings is by considering earnings per share which outlines how much income was generated per share of stock outstanding. Google had 332,846 shares outstanding at the end of 2013 and had a net income of 12,920 which result in earnings per share of $38.82. The relationship between the price and earnings is known as the price per earnings ratio which divides the stock price by the EPS. Since the stock price was at 1.17k at the time of earnings release, the P/E ratio was 30.139. This means that the investor pays $30.14 to capture $1 of the company's earnings. The average P/E in the 2000's was 20.2 for the 2000's so Google fell short of that metric. The high P/E likely indicates that the market believe that Google is capable of high future growth. Since Google failed to meet their projected earnings in the fourth quarter it makes sense that the stock price initially declined.

d. Compare Google's 2013 stock price performance with the performance of the broader set of firms trading on the NASDAQ exchange.

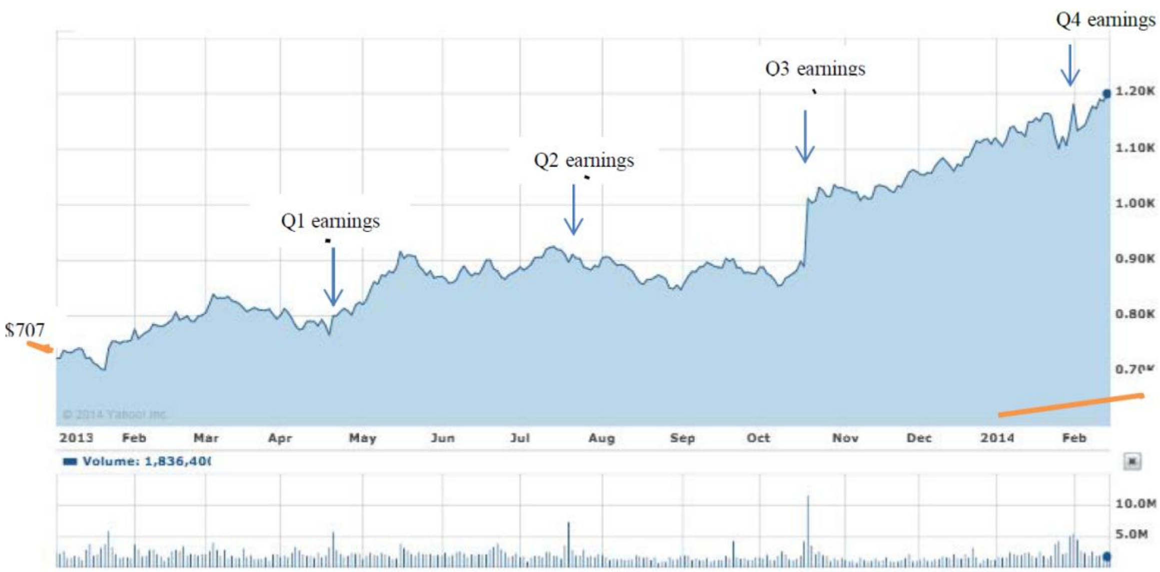
In the first three quarters, Google's stock performed similarly to the overall NASDAQ Index. Before the third quarter's earnings were released the NASDAQ had improved by a cumulative stock return of around twenty-five percent. Almost immediately after the Q3 earnings report was released the google stock shot up to a forty percent return while the NASDAQ remained steady jumping to just below thirty percent. Over the fourth quarter Googles stock continued to rise at a superior pace to the NASDAQ without sacrificing the initial separation it garnered after the release of Q3 earnings. Over the fourth quarters Googles stock rose from forty percent return to nearly a sixty percent return for a gain of twenty percent In that same time period the NASDAQ rose from around thirty percent to just under forty percent but at the time of Q4 earnings, the NASDAQ slumped back down to below thirty percent before recouping the loss in January and February of

2014.



e. 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.

It appears from the graphic that the January 30, 2014 earnings release was perceived as "bad news" because it caused a sharp drop in price at the beginning of the month of February. At January 30, 2014 the stock price stock at around 1.17k but after the earnings release it slumped to approximately 1.13k. In terms of return this dropped Googles cumulative return from around sixty three percent to around 57 percent. Over the month of February the stock recovered but indicating that the press release itself was viewed as “good news” by investors. Although investor expectations were not met by the Q4 earnings release which shouwed earnings per share nineteen cents below expectations the notion that revenues rose from a key segment of Googles portfolio was encouraging and prompted a bounce back. In the lead up to the release Google had experienced a nearly ten percent spike in return but that was mostly diminished by the poor earnings release, by the end of February the loss had been recovered and exceeded bringing the share price up to 1.20k indicating that the press release had a desirable effect for Google.



f. 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?

The Wall Street Journal article starts by noting that Google posted a 17% increase in both revenue and net income in the fourth quarter compared to the prior year. This correlated to a revenue of $16.9 billion which exceeded analyst projections by $0.1

billion. This revenue growth was likely what drove Googles shares up 2.6% by the end of trading. This good news came along with disappointing bottom line results including the factor that earnings were only $12.01 per share which fell short of analyst predictions of $12.20 per share. These revelations seem consistent with the positive stock market reaction that followed the press release because they show that despite the earnings per share falling short, the company is operationally sound and likely to continue to capitalize on its core business units in the future.

g. What other factors does the article discuss that might contribute to the markets positive reaction to the earnings press release? Are there any factors that might cause investors to be concerned about Googles recent performance?

App sales rose for the Google Play store which helped Googles “other revenue” line double form the prior year. Also encouraging might be the fact that Google sold off Motorola which had contributed to $2 billion in operating losses since its acquisition and distracted Google with a focus in hardware. The company’s capital expenditures were up 125% from investments in computers and data centers which will contribute to future cash flows. Additionally, the company contributed positively to their overall cash balance and added employees. Of concern to investors may be that the revenues from per-click ad payments were harmed by the shift toward smaller screens of mobile phones where advertisers pay less for ads. In total, the release notes that Google shares rose 60% from the beginning of 2013 showing that investors are not concerned about the shift to mobile devices. Google is countering this issue by creating advertisement listing that have photos and prices to resemble product listing ads and have seen positive results from their testing of the strategy.

3. What I Learned

This case taught me not only what a non-GAAP financial measure is but also the intuition behind a company's inclusion and how to leverage these metrics as an investor. Previously, I would have looked at a company's earnings reports and disregarded a non-GAAP performance measure out of the perception that this would be inherently invaluable because it does not abide by the framework that we are taught in school; however, the non-GAAP metrics are not necessarily invalid just because they adjust the standardized framework. In fact, a thoughtfully adjusted non-GAAP metric may show the core earnings of a company better than the comparable GAAP metric. By excluding losses from discontinued operations and adjustments in fair value which are not relevant in deciding future success of the business the non-GAAP metric may provide a better forward looking analytic if an investor plans to hold the stock for many future years. The non-recurring business activities will not matter for the years to come in which the investor hopes to garner their return so seeing what operating income would have been absent these peripheral transactions is likely to show the investor what they can expect in the future. I learned how to find these numerical metrics in an earnings report and also how to extract qualitative measures from written data like a press release. In the case of Google, the press release gave highlights to reassure investors despite the earnings per share missing their mark based on analysts' predictions. By explaining the reasons for the missed target and offering counter information that will benefit the company's future performance investors regained confidence and the stock recovered the initial loss.

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