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A Study of Financial Reporting Principles through Analysis of Case Studies

Daniel Cooper Hoskins

A Study of Financial Reporting Principles through Analysis of Case Studies

By

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

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ABSTRACT

DANIEL COOPER HOSKINS

A Study of Financial Reporting Principles through Analysis of Case Studies

(Under the Direction of Victoria Dickinson)

The following thesis provides twelve solutions to case studies on various financial accounting standards. These standards are in agreement with Generally Accepted Accounting Principles (GAAP) as set forth by the Financial Accounting Standards Board (FASB). In conjunction with the topics learned in Intermediate Financial Accounting I and II, each case focuses on a separate area of financial reporting. Each area is then applied and analyzed within a specific company. The thesis displays understanding of major accounting principles, financial statement preparation and analysis, and current topics in accounting. The case studies were completed with the direction of Dr. Victoria Dickinson under the requirements for the University of Mississippi, Sally McDonnell Barksdale Honors College, and Patterson School of Accountancy ACCY 420 course in the 2018-2019 academic year.

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Case 1: Data Analytics

CaseWare IDEA®

Daniel Cooper Hoskins

September 5, 2018

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Introduction

CaseWare IDEA® is data analytics software that emphasizes efficiency and maintaining integrity while sorting through high volumes of data. This software allows the user to import data from spreadsheets or any other accounting program into their user friendly system. The program then creates a variety of charts and field statistics so that the user can quickly see patterns, trends, and outliers. Along with these patterns, trends, and outliers the system also searches for relationships that may not be logical then highlights correlations in the data you would not typically think about. IDEA® records every step of this analysis process giving the user a clear audit trail so the process can be repeated for future analysis.

The goal of this case study is to do a critical analysis of CaseWare IDEA® data analytics software. After researching the software I will identify the purpose of this tool, describe how it is used to make business decisions, and determine its usefulness in business settings to increase efficiency and effectiveness in auditing and tax planning. Finally, I will outline why I believe firms should invest in the acquisition of and training in CaseWare IDEA®.

Based on what I have learned during my research, I feel that CaseWare IDEA® will have a positive impact on my future career because I now understand that in any business you work for information will be coming to you in a variety of formats and contain mountains of information. It is important to be able to compile all of the different data, compare it, and look at trends in order to make intelligent decisions and continue to be a profitable business.

The Purpose of CaseWare IDEA®

CaseWare IDEA has a variety of functions which allow users to analyze and make decisions based on large data sets from multiple of sources extremely quickly. Their data analysis program pinpoints patterns, trends, duplicates, outliers, correlations, or unusual transactions then creates visuals while at the same time tracking every step taken. Members of a business can now make their decisions quickly while using summary information from a large pool of data that can be proven valid.

More often than not the data you need is split across different teams or departments in the business. IDEA's easy data import is a universal file converter that allows business members to import data from virtually any source, including PDFs, text files, reports, and data from ODBC and SAP and combine them into a new file. After this file is created IDEA's Relate helps you match and combine common fields so all the data that pertains to one customer is in the same place. In addition to combining the data, the Fuzzy Duplicate identifies similar records and highlights them. This allows you to detect data entry errors such as recording something multiple times. After all the data is compiled and sorted, IDEA's Visualization feature can calculate more than 100 commonly requested statistics and create line, scatter, bar, pie and treemap charts for members of the business to look at before making decisions.

Finally, in addition to all these functions IDEA allows you to build your own custom analysis programs using three different scripting languages IDEAScript, Visual Script, and Python. This way you can still use the file converting feature then run any analysis you want.

Use of CaseWare IDEA® in Auditing and Tax Planning

CaseWare IDEA makes the audit process much more simple and efficient with its drill don capability, project overview feature, and relate function.

It is impossible to go through every transaction of a company during the audit process. IDEA's Drill Down capability uses five sampling methods help auditors estimate characteristics of the whole based on a subset and come up with valid conclusions. The five sampling methods are systematic (every 1000th record), random (number of items chosen at random), stratified random (a specified number of items selected randomly from within range bands), monetary unit (every 1000th dollar), and classical variables sampling.

IDEA's Project Overview feature graphically shows all of the tasks completed within a project, including when databases are created, deleted or changed. This history can be shared with management and viewed by auditors to make sure accounts are not being tampered with.

Finally, IDEA's Relate function is great for auditing because you can match things such as purchase order numbers to vendor or customer tables to check for errant accounts. You can also match payroll and employee tables to make sure the correct amount of money is being distributed to the right person.

Businesses want to pay as little in taxes each year as possible. In order to minimize the amount of taxes a business has to pay and keep as much money in their pockets as they can, companies need to make sure they are accurately reporting their income and paying the correct amount of taxes.

There are three ways that IDEA helps with tax planning and insures that at the end of the year your business will pay the correct amount in taxes. First, the program reconciles the general ledger, financial statements, and tax returns to give the accurate amount of taxable income. Next, the program summarizes tax returns to reconcile taxable earnings to payroll and annual returns. Finally, in regards to sales tax the software looks at sales transactions from unedited point-of-sales transaction files.

One interesting feature that has to do with both audit and tax planning in IDEA is the Target Fraud Zapper. Some people have figured out how to make electronic sales transactions disappear. As a result this makes the taxes owed on the revenue from those transactions disappear as well. This tool produces two sets of accounting records which can be compared to one another by tax auditors to insure ever transaction is reported and taxed.

Letter on Why We Should Invest in CaseWare IDEA®

To: Dan Smith

From: Cooper Hoskins

Date: September 5th, 2018

Subject: IDEA Acquisition

After doing some research I feel that purchasing and training our employees is CaseWare IDEA data analytics software would be extremely helpful for the firm moving forward in the future. First off, all of our data is in different formats and with different teams. This could help to consolidate everything into one format and remove any duplication. Also we currently do not have the capability to create detailed visuals and often miss outliers or trends that are not as apparent in our data. This program would highlight those while at the same time giving us an audit trail. Worse case if there is a function the system is missing we can just have the IT team code an addition to the program.

For an internal audit I believe this program would be extremely beneficial. It would allow us to look at multiple types of random samples, make sure that accounts are not being tampered with, and insure that all our money is going to the correct place we intended it to. In regard to tax planning this program will make sure we pay the correct amount in taxes each year so that we do not over pay an lose money or pay too little and get in legal trouble. Being able to have reports on all our data in combination with the fact that everything I have read says it is extremely easy to train your existing employees in this system leads me to believe that we should purchase CaseWare IDEA software for the firm.

Case 2: Financial Statement Preparation

Rocky Mountain Chocolate Factory

Daniel Cooper Hoskins

September 11, 2018

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Objective of Case Study / What I Have Learned:

The goal of this exercise was to take information from Rocky Mountain Chocolate Factory, Inc.'s past financials, go through some of their transactions that occurred in 2010, and then create a general journal, income statement, and balance sheet. During this process journal entries, adjusting entries, and closing entries had to be made as well as determining where transactions would appear in the statement of cash flows.

After completing this exercise I learned a lot about formatting financial statements in excel and a ton of different tricks you can do in excel to work more efficiently. I also learned how to input all of your financial information into an electronic general journal and then create financial statements based off of it. Finally, in the past I had had some trouble with the closing process. This exercise really helped me figured out exactly how that process should be done in a very practical way.

Questions

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

Prior to viewing Rocky Mountain Chocolate Factory's balance sheet, I would expect there to be accounts for accounts receivable (customers will not always pay for their product right away) , equipment (since they are a premium chocolate manufacturer), and accounts payable (money owed to employees or spent on raw materials used). The accounts that would constitute major assets would be their property, plant, and equipment. Finally, their major liabilities could be bonds payable or long term notes payable.

Based on the transactions you recorded in parts b and c, list at least three adjustments or reclassifications that might need to be made prior to preparing the final financial statements.

Based on the transactions I have already recorded, a few adjustments that could be needed prior to preparation of financial statements are adjusting for the amount of products that are in inventory, recording depreciation on equipment, or paying salaries to employees.

General Journal

	Beginning Balance (February 28, 2009)	Beginning Balance	Purchase Inventory	Incur Factory Wages	Sell Inventory for Cash and on Acct.	Pay for Inventory	Collect Receivables	Incur SG&A (Cash and Payable)	Pay Wages	Receive Franchise Fee	Purchase PPE	Dividends Declared and Paid	All Other Trans.	Unadjusted Trial Balance
Debit	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 Receivable	4,229,733			5,000,000		(4,100,000)						(702,207)	4,427,526
	Notes Receivable, Current	0											91,059	91,059
	Inventories	4,064,611	7,500,000	6,000,000	(14,000,000)								(66,328)	3,498,283
	Deferred Income Taxes	369,197											92,052	461,249
	Other	224,378											(4,215)	220,163
	Property and Equipment, Net	5,253,598									498,832		132,859	5,885,289
	Notes Receivable, 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	91,057											(3,007)	88,050
Credit	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)					0
	Other Accrued Expenses	531,941						3,300,000					(2,885,413)	946,528
	Dividend Payable	598,986										3,709	(1)	602,694
	Deferred Income	142,000								125,000			(46,062)	220,938
	Deferred 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 Earings	5,751,017										(2,407,167)		3,343,850
	Sales	0			22,000,000								944,017	22,944,017
	Franchise and Royalty Fees	0											5,492,531	5,492,531
Debit	Cost of Sales	0			14,000,000								693,786	14,693,786
	Franchise Costs	0											1,499,477	1,499,477
	Sales & Marketing	0						1,505,431						1,505,431
	General and Administrative	0						2,044,569					(261,622)	1,782,947
	Retail Operating	0						1,750,000						1,750,000
	Depreciation and Amoritization	0												0
	Interest Income	0											(27,210)	(27,210)
	Income Tax Expense	0											2,090,468	2,090,468
	A = L + OE + R - E	0	0	0	0	0	0	0	0	0	0	0	0	0

	Beginning Balance (February 28, 2009)	Unadjusted Trial Balance	Adjust for Inventory Count	Record Depreciation	Wage Accural	Consultant's Report	Pre-Closing Trial Balance	Closing Entry	Post-Closing (Ending) Balance	Actual February 28, 2010 F/S Figures
Debit	Cash and Cash Equivalents	3,743,092					3,743,092		3,743,092	3,743,092
	Accounts Receivable	4,427,526					4,427,526		4,427,526	4,427,526
	Notes Receivable, Current	91,059					91,059		91,059	91,059
	Inventories	3,498,283	(216,836)				3,281,447		3,281,447	3,281,447
	Deferred Income Taxes	461,249					461,249		461,249	461,249
	Other	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 Receivable, Less Current Portion	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	88,050					88,050		88,050	88,050
Credit	Accounts Payable	877,832					877,832		877,832	877,832
	Accrued Salaries and Wages	0			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
	Deferred Income	220,938					220,938		220,938	220,938
	Deferred 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 Earings	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)	0	22,944,017
	Franchise and Royalty Fees	5,492,531					5,492,531	(5,492,531)	0	5,492,531
Debit	Cost of Sales	14,693,786	216,836				14,910,622	(14,910,622)	0	14,910,622
	Franchise Costs	1,499,477					1,499,477	(1,499,477)	0	1,499,477
	Sales & Marketing	1,505,431					1,505,431	(1,505,431)	0	1,505,431
	General and Administrative	1,782,947			639,200		2,422,147	(2,422,147)	0	2,422,147
	Retail Operating	1,750,000			6,956		1,756,956	(1,756,956)	0	1,756,956
	Depreciation and Amoritization	0		698,580			698,580	(698,580)	0	698,580
	Interest Income	(27,210)					(27,210)	27,210	0	(27,210)
	Income Tax Expense	2,090,468					2,090,468	(2,090,468)	0	2,090,468
	A = L + OE + R - E	0	0	0	0	0	0	0	0	

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

Revenues	
Sales	22,944,017
Franchis and Royalty Fees	5,492,531
Total Revenues	**28,436,548**
Costs and Expenses	
Cost of Sales	14,910,622
Franchise Costs	1,499,477
Sales and Marketing	1,505,431
General and Administrative	2,422,147
Retail Operating	1,756,956
Depreciation and Amortization	698,580
Total Costs and Expenses	**22,793,213**
Total Operating Income	**5,643,335**
Other Income	
Interest Income	27,210
Total Other Income	**27,210**
Total Income Before Income Taxes	**5,670,545**
Income Tax Expense	(2,090,468)
Net Income	**3,580,077**

Rocky Mountain Chocolate Factory, Inc.
Balance Sheet
February 28, 2010

Assets	
Current Assets	
Cash and Cash Equivalents	3,743,092
Accounts Receivable	4,427,526
Notes Receivable, Current	91,059
Inventories	3,281,447
Diferred Inome Taxes	461,249
Other	220,163
Total Current Assets	**12,224,536**
Property and Equipment, Net	**5,186,709**
Other Assets	
Notes Receivable, Less Current Portion	263,650
Goodwill, Net	1,046,944
Intangible Assets, Net	110,025
Other	88,050
Total Other Assets	**1,508,669**
Total Assets	**18,919,914**
Liabilities and Stockholder's Equity	
Liabilities	
Accounts Payable	877,832
Accrued Salaries and Wages	646,156
Other Accrued Expenses	946,528
Dividend Payable	602,694
Deferred Income	220,938
Deferred Income Taxes	894,429
Total Liabilities	**4,188,577**
Stockhold's Equity	
Common Stock	180,808
Additional Paid-In Capital	7,626,602
Retained Earnings	6,923,927
Total Stockholders' Equity	**14,731,337**
Total Liabilities and Stockholders' Equity	**18,919,914**

Sections of The Statement of Cash Flows

For each transaction, indicate whether the transaction would appear in the "operating", "investing", or "financing" section of the statement of cash flows.

Balance Sheet Accounts		
Operating	**Investing**	**Financing**
Accounts Receivable	Property and Equipment, Net	Notes Receivable, Less Current Portion
Notes Receivable, Current		Common Stock
Inventories		Additional Paid-In-Capital
Deferred Income Taxes		Retained Earnings
Accounts Payable		Dividend Payable
Accrued Salaries and Wages		
Other Accrued Expenses		
Deferred Income		

Income Statement Accounts		
Operating	**Investing**	**Financing**
Depreciation and Amortization		
Net Income		

	Debit	Credit	Debit	Credit
Part B: Journal Entries				
1)	Raw Materials (Inventory)		7,500,000	
		Accounts Payable		7,500,000
2)	Factory Wages Expense (Inventory)		6,000,000	
		Accrued Salaries and Wages		6,000,000
3)	Cash		17,000,000	
	Accounts Receivable		5,000,000	
		Sales		22,000,000
	Cost of Goods Sold		14,000,000	
		Inventory		14,000,000
4)	Accounts Payable		8,200,000	
		Cash		8,200,000
5)	Cash		4,100,000	
		Accounts Receivable		4,100,000
6)	Sales and Marketing Expense		1,505,431	
	General and Admin. Expense		2,044,569	
	Retail Operating Expense		1,750,000	
		Cash		2,000,000
		Other Accrued Expenses		3,300,000
7)	Accrued Salaries and Wages		6,423,789	
		Cash		6,423,789
8)	Cash		125,000	
		Deferred Income		125,000
9)	Property and Equipment		498,832	
		Cash		498,832
10)	Retained Earnings (Paid Dividends)		2,407,167	
		Dividends Payable		3,709
		Cash		2,403,458
Part F: Adjusting Journal Entries				
12)	Cost of Sales		216,836	
		Inventory		216,836
13)	Depreciation and Amoritization		698,580	
		Property and Equipment		698,580
14)	Accrued Salaries and Wages			
		General and Administrative Expense		639,200
		Retail Operating Expense		6,956
15)	None			

Case 3: Scenario Analysis

Daniel Cooper Hoskins

September 19, 2018

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Introduction

What was the case about?

The goal of this case was to listen to three different scenarios that Dr. D's students have faced in the recent past and that we all may experience in the near future as we transition from college to the business world. After listening to the situations we then had to develop our own opinion on the topic and have an in class debate.

What did I learn from this experience?

I stayed pretty true to my original thoughts on the subject matters, but I found it very interesting to listen to other people's opinions and the justification behind them. I have always been very interested in why people believe what they do. This case first off made me question what I wanted to do with my life in the next few years even more than I already had. It also made me realize that I have no clue exactly what route I want to take and the time to make a decision is coming up fast. As a result, I really need to make a decision soon about what I want to do and where I want to live.

The main thing my opinions are grounded in is the fact growing up I saw so many of the people I knew going to jobs that they absolutely hated. Personally, I have interned in the accounting department of a t-shirt manufacturing company for the last two years and even though I was good at the job I really did not like it at all. As a result, I have determined that no matter what route I take the most important thing to me is enjoying what I do. There is no point in doing a job that you hate because no matter how much money you make you will not be happy.

I am going to work as hard as possible so that I can hopefully get an internship with one of the big four firms. I really want to see what it would be like to be a public accountant. But, truly decided to major in accounting at Ole Miss because I viewed it as the best possible way to develop a set of skills that would allow me to open up my own business one day in the future in an area that I am interested in and passionate about. As a result, I tended to side more with the students in all the cases that wanted to use this great accounting program to make themselves as marketable to other companies as possible and pursue their true areas of interest.

Scenario 1

In this scenario a student is trying to justify going to law school after completing their internship with a big four accounting firm, rather than getting their masters and going back to work for that same firm. The reason this student wants to do the internship is because it would look good on their resume when applying to law school. Does the student have a valid point?

I do believe that this student has a valid point in wanting to take the big four internship opportunity and then apply for law school. First off, a tax internship at a big four firm could give this student a lot of practical knowledge that would be very useful while then are in law school or and practicing tax law. Also, this experience with a major company really would help to set them apart from all the other students applying for the same spot they are at a law school. I honestly feel like it is so unique that it would allow that student to get into a law school that they would not normally get into. This is the same reason why I took the opportunity to join the CME program here at Ole Miss. When it comes time for me to apply to work at these firms having both an accounting and engineering background gives me a more unique skill set that could be very useful to some companies. It is also an interesting discussion point that would set me apart and make me stand out from other accounting majors that just typically minor in finance. I personally believe you should do whatever you can do to get a unique and diverse set of skills. This will give you the opportunity to go in a variety of different routes with your career.

I would also still encourage the student to take the internship even if at the start they intend on going to law school because what if during the job they realize that they really like the work and want to pursue a career in public accounting. They would of never known this is they decided to opt out of the internship at the start because their plan was to go to law school. Finally, during my internship over the last two summers I frequently had to work with the CFO and the company's lawyer on a variety of different cases. As a result, going to law school and having a background in accounting would open up many other opportunities because I feel like any company would want to hire someone with these skills as their CFO.

Scenario 2

In this scenario the student is not into accounting and after college they want to be an investment banker or a consultant. But, because the Ole Miss accounting program is so highly ranked, the student figures they would be better off majoring in accounting, doing a big four internship, and then pursuing career in one of those other fields. They believe companies like accounting majors more and would pay an accounting major more money to do a job in investment banking or consulting then someone who majors in one of those areas. Does the student have a valid point?

I do believe that this student has a valid point because I too want to get an accounting degree for the purpose of learning the unique skills that would allow me to work in any area of the business world that I want to. Accounting is the language of business and accountants can do all other business disciplines but the others cannot. As a result, why wouldn’t you get an accounting degree in you had the opportunity to? It makes you more marketable than any other undergraduate business degree.

An accounting degree is extremely versatile and that coupled with experience at a big four firm would make any company in your true area of interest want to hire you. Even over people who just got degrees in that subject area. By hiring an accounting major the company would gain an employee with a different skill set who could solve other problems while at the same time do the same work as someone who has a degree in that field. This is mutually beneficial because at the same time this would also give you a leg up. If you work hard and get to the point where you become irreplaceable, then the company would be forced to continue to promote you and give your raises.

One thing we talked about a lot in class was the idea of taking up slots. Even if you do not have the intention of working for a big four firm I feel like if you are qualified you should still take that opportunity to intern. By doing this internship you are increasing your skill set and bettering your resume which will make you more appealing to any other potential employer. Taking a slot from someone else should not matter because there is no common curtesy in business so you should do whatever you can to be able to get the best job possible. Another bonus of the internship is if you really did an amazing job they could give you enough incentives to stay rather than going to work for another company. Either way taking the internship would be extremely beneficial to your future career no matter what route you end up taking.

Scenario 3

Part 1:

In this scenario a grading assistant has access to Dr. D's email and see an email exchange between her and a grad student she used to teach. The student wants to know if even though they did their internship at a big four firm in DC, would they be able to transfer to the Dallas office and work there full time instead? They enjoyed working in DC but they want to move back home and start their career in Dallas. If this is possible, the student wants to know what the process would be for transferring from one office to another. Does the student have a valid point?

First off, I feel that since the student has already interned for the big four firm they should be taking the initiative to reach out to someone in the Dallas or D.C. office about changing locations to see if it is possible rather than contacting Dr. D. Even though the D.C. office gave that student the opportunity to intern there and invested a lot of money I their training, if the student wants to be in Dallas they should do whatever it takes to get switched there. If you do not like the city you are in or the people you are working for there then there is no reason to start your career some place you do not want to be. This is the beginning of your professional career where it is important to start out strong, do well, and make connections in a place where you could see yourself moving up and working in the future. Connections are extremely important and you want them to be in a place you would want to be moving forward. Also while you are young this is your opportunity to move yourself to where you want to be before life happens or you get promoted and you are more or less stuck in that location. The student could get stuck in D.C. and moving back home could become much more difficult in the future. Finally, regardless of anything you need to be transparent with the company you work for about your goals.

Part 2:

Dr. D's response to the student's email was to be patient. The Dallas office has a lot of people they will be bringing back full time after doing their internships there so they may not have a slot for the student. She recommended to the student that they should stay in DC so that the DC office could recoup some of their investment on recruiting the student and having them intern at their office. She said that the student may have to work a while, but if they are a high performer then they might be able to transfer after a few years. The student responded by saying that they enjoyed DC but really want to go back home to Dallas. Dr. D then recommended reaching out to the campus recruiter for that particular firm. Does the student have a valid point?

I feel that if the student is not able to transfer to the Dallas office with that particular big four firm, they should try to find a different job with another company in the Dallas area rather than going to work at the D.C. office. First off, I strongly believe you should not compromise and live in a place where you are not happy. Also at this point the student would already have a big four internship on their resume which would make them extremely marketable to other smaller companies in their desired location. There is no point in starting work somewhere and establishing your career in a place you do not want to be with the hopes of passably transferring in a few years. After that time you still may not be able to transfer or if you do all of your connections would be in a place you no longer life and you would have to start over. I think a young professional should start their career in a place they are happy and could see themselves living moving forward.

Case 4:

Accounting for Debit Securities, Sales, and Impairments

General Bank

Daniel Cooper Hoskins

October 3, 2018

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Introduction / What I Learned

This case examines how banks report the decline in value of their securities based upon intent to hold or sell. If a bank reports that they intended to hold the securities, they would not be required to mark them down to their fair value. But, if the bank decided they wanted to sell one of their securities, they would be required to mark down their entire portfolio. After doing this case I have a better understanding of what exactly a security is and how a financial institution deals with fluctuations in their value. I also now understand a recent ASU that is going to change how accountants and bankers who deal with AFS securities moving forward.

Question 1

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

			20x2			
Security Type	CUSIP	Description	Amoritized Cost	Fair Value	Gain	Loss
State & Political Subdivisions	0XXXXX003	Municipal Bond - City of Los Angeles	$ 57,652	$ 42,968		$ 14,684
Mortgage-backed Securities	0XXXXX015	FHLMC Residential Single Family MBS - 3	$ 77,759	$ 77,586		$ 173
Mortgage-backed Securities	0XXXXX025	FHLMC Residential Single Family MBS - 13	$ 52,188	$ 29,650		$ 22,538
Mortgage-backed Securities	0XXXXX030	FNMA Residential Single Family MBS - 3	$ 66,785	$ 54,457		$ 12,328
Mortgage-backed Securities	0XXXXX067	FNMA Residential Multi Family MBS - 5	$ 39,545	$ 55,883	$ 16,338	
Mortgage-backed Securities	0XXXXX076	Private Label Resid. Multi Family MBS - 4	$ 42,115	$ 13,424		$ 28,691
Other Securities	0XXXXX096	Corporate Bonds - JKL Corporation	$ 50,000	$ 57,867	$ 7,867	
					$ 24,205	$ 78,414
*Numbers in thousands						$ 54,209

Assuming that General Bank does sell these securities shortly after the year's end in order to free up cash for employee's year-end bonuses and potential acquisitions in the first half of 20x3, General Bank does have an impairment loss on the seven securities that should be recognized on their next income statement. According to FASB update 2016-13, "available-for-sale accounting recognizes that value may be realized either through collection of contractual cash flows or through sale of the security." By selling these securities the result is an increase in cash of $331.835 million to meet General Bank's needs but will also realize a loss of $54.209 million into earnings.

Since General Bank has other means to raise the needed cash (FHLB Advances and Fed Funds), it is a voluntary choice to liquidate these funds. As a result, even though the bank designates its securities as AFS (no unrealized changes in value for these securities affect earnings) which is acceptable by current GAAP since they sold the securities the loss is realized.

Also, under current GAAP for a bank to avoid recognizing impairment, it must be able to assert that debit securities in an unrealized loss position have not experienced credit deteriorations and that it has the intent and ability to hold the securities until prices recover. Generic bank believes that declines in value of it debit securities relate primarily to changes in interest rates and not credit deterioration. The bank also claims it has the intent and ability to hold these securities in their portfolio until they mature or the unrealized losses recover. As a result, no impairment charge has yet been taken and no allowance for credit losses established. Even though this is the case by choosing to sell the securities before they matured or unrealized loss was recovered, then the securities would be deemed impaired and General Bank has to realize the loss from selling these securities at fair value on its income statement.

Question 2

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

Assuming that General Bank does sell the securities shortly after year end in early 20x3, according to FASB update 2016-13 General Bank will still have to recognize an impairment loss on the other 93 securities. Even though they intend to hold on to them until they mature or the unrealized loss is recovered "the amendments in this update indicate that an entity should not use the length of time a security has been in an unrealized loss position to avoid recording a credit loss."

This change was made because current GAAP "restricts the ability to record credit losses that are expected, but do not yet meet the 'probable' threshold." This delayed recognition of credit losses also would result in a potential overstatement of assets. The update replaces "the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates." This credit loss relating to debt securities should now be recorded through an allowance for credit losses for however much fair value is below amortized cost.

In the case of General Bank this means that they should not only recognize the loss on the securities they already sold but also include and allowance for credit loss on their financial statements for $373.140 million. This is the total amount fair value is below amortized cost of $427.349 million minus loss on securities sold.

Question 3

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

My answer would not change if I assumed the role of the external auditor. As external auditor I would want to recognize an allowance for credit loss from the other 93 securities still being held. General Bank is a publically traded company so as an auditor I would want to give current or future investors an accurate representation of the company's financial position. If not, it could lead people to invest in a business they believe is a lot more profitable than it actually is. Also as a result of doing this according to FASB update 2016-13 entities, "will be able to record reversals of credit losses (in situations in which the estimate of credit losses declines) in current period net income, which in turn should align the income statement recognition of credit losses with the reporting period in which changes occur." Again this will give investors a better idea of how much money the bank is actually making rather than just reporting based on current GAAP standards. This will also allow for a correction if the loss incurred is less than expected.

FASB update 2016-13 states that "for public business entities that are U.S. Securities and Exchange Commission (SEC) filers, the amendments in this Update are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years." Even though this change does not go into effect immediately if I assumed the role of bank regulator I would still want to disclose this loss as soon as possible. I would do this so that it does not look like the bank is trying to hide something and it would prevent an extreme financial position change when the regulation goes into effect. If I were to wait that drastic change could scare investors and cause them to lose faith in the bank.

Question 4

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?

My assessment would not change if the securities sold or all the securities held had been collectively in a net gain position. Either way, in order keep with current accounting standards and report the financial position of the bank accurately for all current and future investors, all gains or losses on held or sold securities should be represented in the financial statements. This gives a true representation of where the company actually stands. In this case it would just be a lot better if a gain was being reported on these securities rather than a loss but either way it should be reported.

Question 5

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. 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?

Assuming that General Bank is now just adequately capitalized and access to other forms of borrowing to meet liquidity needs are limited (they no longer have access to FHLB advances or Fed Funds), General Bank still has an impairment loss on securities other than the seven sold. General Bank would realize the loss on the securities they did sell to meet liquidity needs and in order to be consistent with current accounting standards the bank would have an allowance for credit loss on the other 93 securities continuing to be held. General Bank is honestly now more likely than before to sell some of their securities at a loss because they no longer have any other way to get liquid capital to fulfill borrowing obligations as they become due.

Case 5: City Selection

Dallas, Texas & Tampa, Florida

Daniel Cooper Hoskins

November 7, 2018

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Introduction / Purpose of this Case

The goal of this case was to examine the top two cities I am considering applying for internships and starting my career in after I finish college. Currently, my top two cities are Dallas, Texas and Tampa, Florida. Prior to this I had a general idea about what it would be like to live in either of these cities. But, I had not even considered many of the little details or logistics that go along with actually living in either of these areas.

In this case I had to answer 16 city specific questions that looked at general characteristics of each city, costs associated with living in either city, and other aspects that would play a major role in the type of experiences I would have if I were to live and work there. After doing my research I am very excited about the opportunity to live in either Dallas or Tampa. But, I did not realize how expensive it would be living in areas so close to downtown in either city. I also didn't think about a lot of the little expenses I would encounter that really add up. Even making a decent amount of money right out of college money could get tight if I do not budget properly.

I am extremely excited to start this next chapter of my life after college in a new city. I am still a little nervous about the entire situation though. But, I now have a better idea about all the factors that are involved in living in either of these cities which has eased some of my nerves. After doing this case I am more confident that I will make the best decision for myself moving forward.

1. What is the population?

The current population of Dallas, Texas is estimated at 1.3 million. The Dallas metropolitan area is much larger and has a population of 6.8 million.

The current population of Tampa, Florida is estimated at 350,000 and the greater Tampa Bay metropolitan area has an estimated population of 2.8 million.

2. Describe the climate and seasonal fluctuations.

Dallas experiences four distinct seasons. The summers are hot and muggy while the winters are mild yet windy. Over the course of the year the temperature typically varies from 39°F - 96°F and it rarely goes below 26°F or above 102°F. The rainy season occurs in April and May and July and August are the driest months.

The Tampa Bay area has two main seasons. There is a hot and wet season from May through October and a mild and dry season from November through April. The temperature in Tampa is typically between 95°F - 50°F with it being between 95°F - 70°F in the summer and between 70°F - 50°F in the winter. Since Tampa is so close to the Gulf of Mexico and most of the city lies on a smaller peninsula that juts out into the bay the area is typically very humid.

3. Describe the city's topography, scenery, and other geographic or geological features of the area in which the city is located. Include pictures where appropriate.

Dallas is a mostly flat inland city that is most known for its waterways. The Trinity River flows down the west side of the city and within the city are two major lakes, White Rock Lake and Bachman Lake. Dallas also has one of the largest urban forests in the United Sates (the Great Trinity Forest) spanning 6,000 acres.


Trinity River

Tampa is located half way down Florida's west coast about 25 miles east of the Gulf of Mexico. The Tampa Bay separates St. Petersburg from Tampa and connects to the Hillsborough and Old Tampa Bays which border Tampa to the south and west. Downtown is also divided by the Hillsborough River which winds through the city.

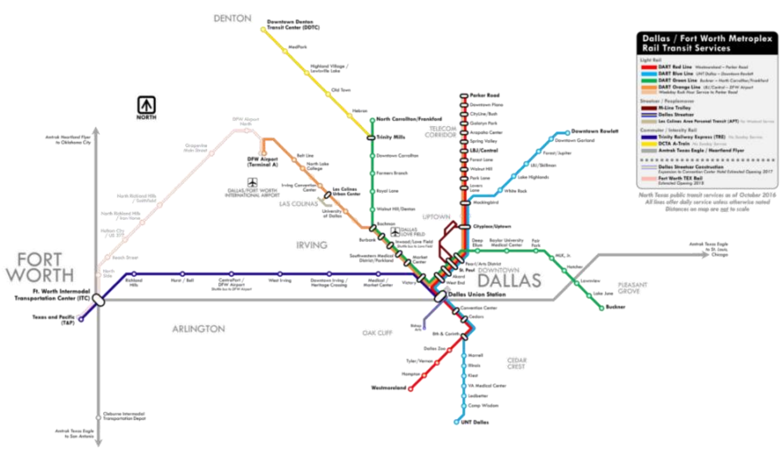

Hillsborough River

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

In Texas and Florida there is no state income tax. As a result, all I would have to pay in either location would be federal income tax which is 22% for people making between $38,701 and $82,500. Based on a starting salary of $50,000 the total amount of income taxes I would have to pay living in Dallas or Tampa would be $11,000 leaving me with $39,000 post tax income. Also, in Dallas the average property tax is 1.86% and sales tax is 8.25%. In Tampa the average property tax is 0.938% and sales tax is 6%.

5. What transportation hubs are in the city?

Dallas is a very walkable city in the downtown and uptown areas. But, this is not the case with majority of the city. The city is also not designed with any major street grid system with creates a lot of small streets at awkward angles. But, the city does have a large number of major highways that run through the city and out into the suburbs. A great feature of Dallas is the Dallas Area Rapid Transit (DART) public transportation system which provides a variety of services throughout the city including buses, rail, express rail, streetcars, and trolleys. Finally, in the city there are two commercial airports, Dallas/Fort Worth International Airport and Dallas Love Field.



In Tampa there are three bridges that go over the bay and connect the city to the surrounding counties. There are also several freeways that run in and out of the city. In the city Hillsborough Area Regional Transit Authority (HART) operates public busses and streetcars downtown and has 30 local and express routes. Their rapid-transit bus system is called MetroRapid. The TECO Line Streetcar System also runs an electric streetcar service throughout the city along 11 stations and it connects to Tampa Union Station. Finally, Tampa International Airport serves the residents of the city and there are two other smaller airports in the metro area.

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

The city of Dallas supports a diverse group of industries. Technological industries make up the majority, but other major industries include defense, financial services, information technology and data, life sciences, semi contractors, telecommunications, transportation, and processing. The Dallas-Fort Worth area is home to 43% of the state's high-tech workers and 13 privately held companies with at least 1 billion dollars in annual revenue are also headquartered there. Finally, 19 Fortune 500 companies are headquartered in Dallas including ExxonMobil, Nieman Marcus, and Southwest Airlines.

Tampa is home to the largest port in the state of Florida and to 10 Fortune 500 companies. The largest company headquartered in the city is Publix Super Markets and a few other famous companies headquartered there are Tech Data, Outback Steakhouse, and Raymond James Financial. The most prevalent industries in the city are avionics, defense, and marine electronics, healthcare, business, information, and financial services, manufacturing (microelectronics and medical devices), marine sciences, maritime, and tourism.

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

The quality of healthcare is actually a major draw for people looking to move to the Dallas area. The U.S. New & World Report has consistently ranked many of Dallas' hospitals among the best in the nation in its America's Best Hospitals report. Baylor University Medical Center – Dallas is consistently ranked in the top in 6 different areas including orthopedics, gynecology, kidney disease, digestive disorders and endocrinology, respiratory disorders, and urology.

Tampa and the surrounding suburbs have over 20 hospitals, 4 trauma centers, and multiple cancer treatment centers. Three of these hospitals rank among America's best hospitals according to The U.S. News & World Report. Tampa is also home to a few very prominent health research centers including the H. Lee Moffitt Cancer Center & Research Institute and USF's Byrd Alzheimer's Institute.

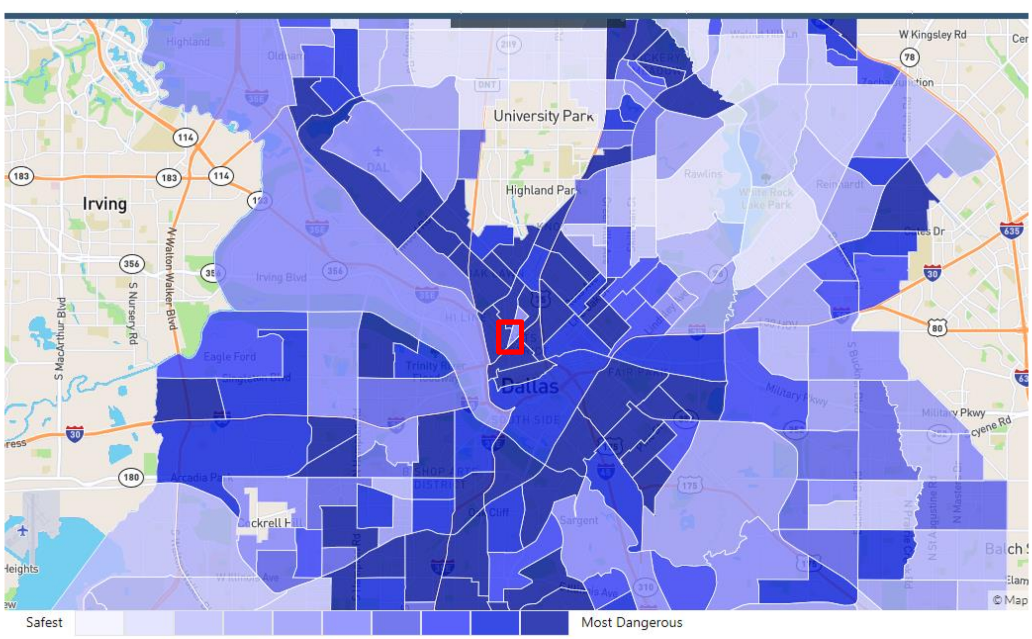
8. What types of crime are common within the city and where are the locations within the city to avoid?

Below is a graphic that shows the rates for specific violet and property crimes in Dallas and then compares those rates to Texas and U.S. averages. Also below is a crime map of the city with the darkest shaded areas being the most dangerous. The 10 most dangerous neighborhoods in Dallas are South Boulevard-Park Row, Northwest Dallas, South Dallas, Cedar Crest, Southeast Dallas, Lake Caroline, Wolf Creek, Fie Mile Creek, Urbandale-Parkdale, and Eagle Ford.

Reported Annual Crime In Dallas

Statistic	Reported incidents	Dallas /100k people	Texas /100k people	National /100k people
Total crime	54,981	4,162	3,194	2,837

Statistic	Reported incidents	Dallas /100k people	Texas /100k people	National /100k people
Murder	171	12.9	5.3	5.3
Rape	767	58.1	48.0	40.4
Robbery	4,604	348.5	119.6	102.8
Assault	4,529	342.9	261.6	248.5
Violent crime	10,071	762	434	386
Burglary	10,948	828.8	533.8	468.9
Theft	26,370	1,996.3	1,978.1	1,745.0
Vehicle theft	7,592	574.7	247.8	236.9
Property crime	44,910	3,400	2,760	2,451

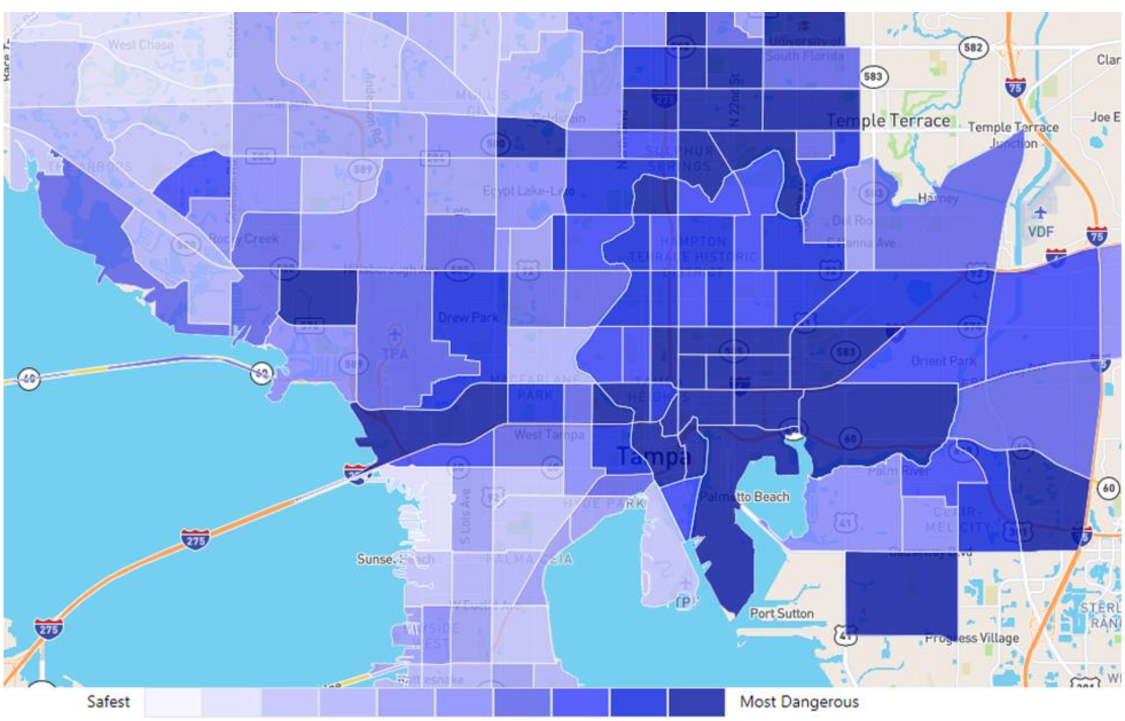


Below is a graphic that shows the rates for specific violet and property crimes in Tampa and then compares those rates to Florida and U.S. averages. Tampa is decently below both Florida and national averages in terms of property crimes. Also below is a crime map of the city with the darkest shaded areas being the most dangerous. The 10 most dangerous neighborhoods in Tampa are Orient Park, Beasley, Northview Hills, Northeast, Grant Park, West Riverfront, Highland Pines, Florence, College Hill, and Woodland Terrace.

Reported Annual Crime In Tampa

Statistic	Reported incidents	Tampa /100k people	Florida /100k people	National /100k people
Total crime	9,706	2,582	3,117	2,837

Statistic	Reported incidents	Tampa /100k people	Florida /100k people	National /100k people
Murder	29	7.7	5.4	5.3
Rape	80	21.3	36.9	40.4
Robbery	488	129.8	97.9	102.8
Assault	1,309	348.2	290.2	248.5
Violent crime	1,906	507	430	386
Burglary	1,477	392.9	486.7	468.9
Theft	5,695	1,515.0	1,990.8	1,745.0
Vehicle theft	628	167.1	209.3	236.9
Property crime	7,800	2,075	2,687	2,451



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

If I were to move to Dallas, Uptown (boxed off in red on the map of Dallas) is not only one of the safest areas close to downtown but it is also a fun area that is very popular with young professionals. There are a lot of really nice restaurants, bars and other things to do after work. One bed room apartments that looked nice without being unreasonable and included all the amenities I would like ranged from $1,300 to $1,500 a month. If I would want to live in this area for the first three years of my career I would like to get a two bedroom apartment and share it with a roommate. Two bedroom apartments ranged from $1,600 to $2,000 a month so having a roommate would cost us each between $800 and $1,000 per month.

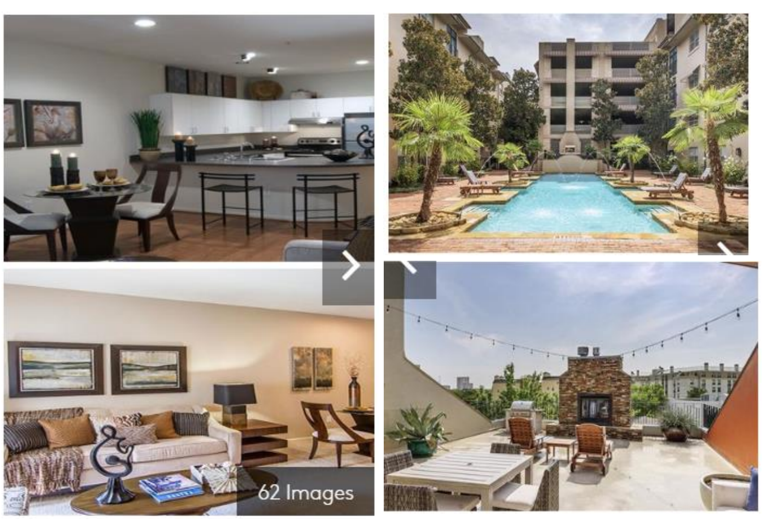
Gables Mirabella

2600 Cole Ave, Dallas, TX 75204 - Uptown

1 Bed 1 Bath (1,000 sqft) - $1,420

2 Bed 2 Bath (1,245 sqft) - $1,815

- Large Pool with BBQ
- Up to Date Fitness Center
- Covered Parking Included in Rent



Post Square

2815 Allen St, Dallas, TX 75204 - Uptown

1 Bed 1 Bath (870 sqft) - $1,350

2 Bed 2 Bath (1,003 sqft) - $1,670

- Resort Style Pool
- Rooftop Courtyard
- Fitness Center
- Parking Included with Rent

If I were to move to Tampa I would want to live in the Channelside District. Channelside is directly east of and extremely close to downtown where I would work and it also has some of the best night life in the city. It is extremely popular among young people who move to the city. One bedroom apartments that were reasonable and included all the amenities I would want ranged from $1,250 to $1,600 a month. If I wanted to live here for the first three years of my career I would most likely get a two bedroom with a roommate. Two bedroom apartments ranged from $1,700 to $2,300 a month so it would only cost us each between $850 and $1,150 per month.

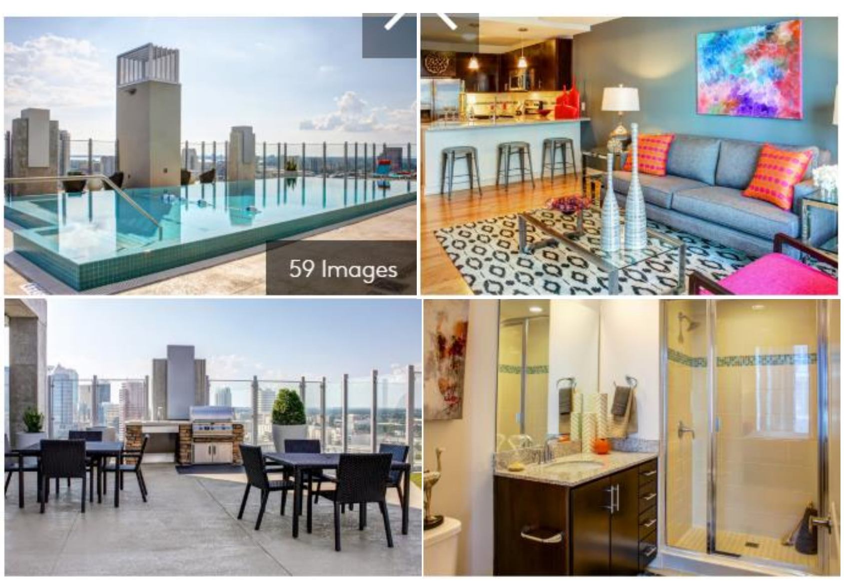
Bell Channelside

1120 E Twiggs Street, Tampa, FL 33602

1 Bed 1 Bath (717 sqft) - $1,410

2 Bed 2 Bath (1,054 sqft) - $1,730

- Every Unit has a Balcony
- Luxury Pool
- Rec. Area and Fitness Center
- Utilities Included
- $35 per Month for Covered Parking



Skyhouse Channelside

112 N 12th St, Tampa, FL 33602

1 Bed 1 Bath (648 sqft) - $1,494

2 Bed 2 Bath (1,029 sqft) - $2,219

- Rooftop Terrace
- Pool with Lounge and Fire Pits
- Fitness Center
- $25 per Month for Covered Parking

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

Uptown is extremely close to all of the Big 4 offices downtown. The apartments I looked at are on average 1.4 miles away from the KPMG and Deloitte offices, 1.5 miles from the PwC office, and 2.2 miles from EY. As a result of these being so close, I would most likely take the M-Line trolley or dive (depending on how parking is at the office is since a spot is included with my rent at both apartments) and I would estimate my commute could take anywhere from 5 minutes on a light day to 20 minutes due to trolley stops or traffic. Either way it is a very short daily commute.

Channelside is about a mile from three of the Big 4 offices in downtown Tampa (KPMG, Deloitte, and EY) and 6 miles from the PwC office. If I worked at any of the three about a mile away I would either walk or take a HART bus to work and my maximum commute time would be about 20 minutes. If I worked at PWC I would either take the bus or drive and I would expect my commute time to be 15 to 30 minutes maximum.

11. Where will you do your grocery shopping?

In Uptown, Dallas there is a Whole Foods, two Kroger's, a Walmart, and two small organic markets evtremely close where I could buy groceries.

In Channelside, Tampa there are a few small grocery stores close by, but if I wanted to go to a larger store like the ones I am more accustomed to I would have to drive a few miles north into the city.

12. How will you do your laundry?

All of the apartments I looked at in Uptown, Dallas and Channelside, Tampa included washers and dryers in each unit.

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

I am a practicing Catholic so I would like to get involved with either St. Peter's Catholic Church in Uptown or Sacred Heart Catholic Church in Channelside. Next, I would like to be involved with the Delta Psi Alumni Association of either Dallas or Tampa. Finally, back home during breaks I volunteer at Stepping Stones Shelter which provides temporary housing for homeless single mothers and their children. I would like to stay involved with an organization similar to this while in either city. In downtown Dallas there is an organization called Family Gateway and in downtown Tampa there is Alpha House of Tampa Inc and they both provide a service very similar to Stepping Stones. I would like to get involved with either of these groups because they do so much to help get women with small children back on their feet and really impact their lives.

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

I am a huge professional football fan so being so close to the Dallas Cowboys would be a huge draw for me, especially since they play the Redskins (one of my favorite teams) every year at AT&T Stadium. In addition to the Cowboys, Dallas has nine other professional sports teams. Dallas is also known for country music. I would be very excited about being able to go to the Dos Equis Pavilion, American Airline Center, or other small concert venues to listen to good, live country music.

Tampa has three professional sports teams and the city operates over 165 parks and beaches covering 2,286 acres within city limits and 42 more in surrounding suburbs covering 70,000 acres. Going to the beach is one of my favorite things to do so this would be a big draw for me. In addition Tampa is a very foodie city. There are a ton of food trucks and interesting restaurants that I would frequent. Tampa is also home to two theme parks and the Florida Aquarium. Finally, every year Tampa has Gasparilla which is a massive festival similar to Mardi Gras.

I have been playing water polo ever since high school and am involved with the club team at Ole Miss. If possible I would like to coach after work for a local high school, college, or youth club team in either city. I would also like to join either the Dallas Water Polo Club or Tampa Bay Water Polo which are masters teams that not only play but helps support local youth water polo clubs. Finally, while at Ole Miss our water polo team joined the CWPA (Collegiate Water Polo Association). This group helps govern and referee club water polo teams at different colleges. In either city I would like to get my certification and referee CWPA games.

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

I am from Baltimore so when I want to travel back to see my family I would take the bus to Dallas Love Field Airport or Tampa International Airport and then fly home. The average cost of a round trip flight from Dallas based on the prices I looked at on Southwest's website would be about $400. The average cost of a round trip flight from Tampa would be about $325.

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

Dallas & Tampa Year 2 Monthly Budget (Based on $60,000 Annual Salary)	
My Income	
Monthly Salary	$5,000
Federal Income Tax (22%)	$1,100
Texas State Income Tax (0%)	$0
Total Income	$3,900
My Expenses	
Rent & Utilities (with roommate)	$1,000
Car Payment & Gas	$400
Phone Payment	$50
Groceries	$250
Medical & Health	$50
Dining & Entertainment	$300
Loan Repayment	$100
Other	$150
Total Expenses	$2,300
Total Monthly Savings	$1,600
Total Annual Savings	$19,200

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

Based on my full analysis of both Dallas and Tampa I would still really want to live in either city. But, I was originally leaning towards Dallas and now I think that Tampa is my number one choice. Even though it will probably cost me more to live in Tampa, I feel like Tampa gives me opportunities to work with industries I am more interested, especially in the areas of electronics manufacturing and maritime. In addition to this I like the fact that Tampa is a smaller coastal city with a higher average temperature. Finally, all the options of fun things I would have to outside of work seemed more appealing to me in Tampa than Dallas. Either way I would be extremely excited to get the opportunity to live in one of these great cities.

The main thing I took away from this case was that no matter what, moving to a new city and going out on my own is going to be a great challenge full of experiences, situations, and expenditures I would never expect. As a result, I need to really stay on top of myself and my finances in order to be as successful as possible. I feel like this case really gave me a preview of all of these things and I will be more prepared for this next step in my life regardless of where I end up.

Case 6: Capitalized Costs and Earnings Quality

WorldCom, Inc.

Daniel Cooper Hoskins

November 16, 2018

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Introduction

In this case I examined the results of capitalizing costs rather than properly expensing them in relation to the WorldCom scandal. First, I looked at what an asset and expense are and in general when costs should be expensed or capitalized as an asset. Next, I looked at how either capitalizing or expensing a cost affects the balance sheet, income statement, and retained earnings statement. After grasping a basic understanding of these concepts, I began to dive into what WorldCom actually did on their books to commit this fraud. I looked at what journal entries they made to capitalize these line costs rather than expense them and how that affected the balance sheet. Then I calculated the depreciation expense that resulted from improperly capitalizing these line costs. Finally, I calculated what WorldCom's net income was in 2001 because these line-costs were improperly capitalized then compared it to what their net income should have been.

Concepts

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

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

In concept statement 6 paragraph 25, FASB defines an asset as “probable future economic benefits obtained or controlled by a particular entity as the result of past transactions or events.” In paragraph 81, FASB defines expenses as “actual or expected cash outflows (or the equivalent) that have occurred or will eventually result of the entity’s ongoing major or central operations.”

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

In general, costs should be expensed when they simply maintain a given level of service, are used up or have expired, and have no future economic value that can be measured. Costs should be capitalized as assets when they have not expired and achieve greater future benefits. In order to capitalize costs, one of three conditions must be present. Useful life must be increased, quantity of units produced must be increased, and quality of units produced must be enhanced.

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

After the initial capitalization, the cost becomes part of the book value of the asset. This increase is done by debiting the asset account. A cash or payable count is credited along with this. Below is an example journal entry:

Laser Engraver	2,000	
Cash		2,000

As stated above when you capitalize a cost there is a debit to an asset account and a credit to a cash or payable account. As a result, there is no net effect on the balance sheet and retained earnings. The income statement is not touched in this case. When a cost is expensed there is a debit to an expense account and a credit to a cash or payable account. As a result, expenses on the income statement will be higher and current liabilities on the balance sheet will be higher. This means that net income will be lower and retained earnings will be lower.

Process

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

For the year ended December 31, 2001, WorldCom reported $14,739,000,000 as line costs. The journal entry to record these transactions for the year would be:

Line Cost Expense	14,739,000,000	
Cash		14,739,000,000

These line costs are cash being paid to other telephone service providers so that WorldCom's customers could make their calls.

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

The types of costs that were improperly capitalized by WorldCom were line costs that should have been expensed. As stated in part c, these costs came from cash being paid to other telephone service providers so the WorldCom's customers could make their calls. These costs do not meet the definition of an asset in concept statement 6 paragraph 25 of FASB because there is no probable future benefit that results from the transaction. As a result, the costs should have remained as an expense rather than being capitalized.

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

Property, Plant, and Equipment	3,055,000,000	
Line Cost Expense		3,055,000,000

These costs were added to PP&E under the long term investments section of the balance sheet and deducted from Line Cost Expense under the operating expenses section of the income statement. As a result of this, net income and retained earnings were both overstated. The statement of cash flows will not be effected.

Analysis

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

First Quarter:	771/22 = 35.045 x 1 =	35.045
Second Quarter:	610/22 = 27.73 x (3/4) =	20.5275
Third Quarter:	743/22 = 33.773 x (1/2) =	16.8865
Fourth Quarter:	931/22 = 42.32 x (1/4) =	10.58
Depreciation Expense for 2001 (in millions):		83.039

Depreciation Expense	83,039,000	
Accumulated Depreciation		83,039,000

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

2001 Pretax Income	2,393,000,000
Depreciation Expense	83,039,000
Capitalized Line Costs	<3,055,000,000>
Pretax Loss	<578,961,000>
Income Tax Discount due to Loss	202,636,350
Minority Interests	35,000,000
2001 Net Loss	<341,324,650>

This loss is material because WorldCom stated that they made $1,384,000,000 during 2001 rather than loss $341,324,650.

Conclusion

When it comes to accounting, there is generally a more beneficial action that has the potential to be unethical and an ethical course of action that could possibly make the company look bad. WorldCom believed that they were just engaging in short-term behavior where the means would justify the ends. But, the situation snowballed and by just changing a small series of journal entries, WorldCom falsely reported hundreds of millions in revenue rather than large losses. This eventually led to delusion of the company, thousands of jobs lost, and fines and severe punishments for higher ups in the company.

This just puts into perspective how important it is to report everything to GAAP standards once I have begun my professional career. Even if pressured and the result of proper accounting negatively effects the business, making the correct ethical decision and reporting based on GAAP standards is vital. Not only do your actions as an accountant reflect the company but you as an individual.

Case 7: Understanding Financial Statements

Starbucks Corporation

Daniel Cooper Hoskins

March 5, 2019

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Introduction

Starbucks is one of the world's largest retailers of premium coffee drinks. In this case I did an in depth analysis of Starbucks' financial statements and the factors that influenced them. The first thing I did was get a good understanding of the nature of the business, how Starbucks generates income, how the financial reporting process works for public companies, and why Starbucks classifies their financial statements as consolidated. This allowed me to better understand what types of factors could influence the statements in both positive and negative ways before getting into the details. At this point it time I also looked at the audit opinion letters from Deloitte, Starbucks' external auditor, to see if they believed the statements were a true representation of the company's financials.

After compiling all of this background information I dove into the financial statements and created my own common sized income statement and balance sheet. I then looked at Starbucks' major assets, intangible assets such as goodwill, cost structure, and how they were financed. From this more in depth look was needed to be taken on Starbucks' revenue recognition policies, which accounts included estimates, and the effect of irregular expenses on the statements. Finally, I determined if Starbucks was profitable and looked at their net earnings, cash from operating activities, and dividends.

Concepts

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

Starbucks is a global retailer of high quality coffee products and accessories. In their stores Starbucks sells premium coffee and tea, sandwiches, pastries, and branded merchandise such as mugs and travel cups. In addition, they sell coffee grounds and k-cups both in store and at other retailers, such as grocery stores, for at home brewing. Starbucks' retail locations are either wholly owned or licensed franchise stores. Starbucks generates its revenue from sales in these two types of stores and from their sales in other retail stores and online.

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

For external reporting purposes, companies generally prepare a balance sheet, income statement, statement of stockholders' equity, and statement of cash flows. Starbucks titles these same statements as consolidated balance sheet, consolidated statement of earnings, consolidated statement of equity, and consolidated statement of cash flows. The key difference is the "consolidated" denotation that Starbucks assigns to their statements. Starbucks does this to show that the statements include totaled figures from the parent company, all of its subsidiaries, and investees that the company controls. Note 1: Summary of Significant Accounting Policies states that the consolidated reports are a sum of earnings from the company's four business segments: "1) Americas, inclusive of the US, Canada, and Latin America; 2) Europe, Middle East, and Africa ("EMEA"); 3) China / Asia Pacific ("CAP") and 4) Channel Development. Teavana, Seattle's Best Coffee, Evolution Fresh and our Digital Ventures business".

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

According to MarketWatch.com, Starbucks has a public float value of $1.2 billion. This number represents the portion of shares of a corporation that are in the hands of public investors as opposed to locked-in stock held by promoters, company officers, controlling-interest investors, or governments. This 1.2 billion mark classifies Starbucks as a large accelerated filer meaning they must generate quarterly financial statements and file them with the SEC within 40 days of quarter-end and annual statements within 60 days of year-end. This is not out of the ordinary. Most publicly traded companies have to generate and file five financial statements a year with the SEC.

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

Like most other companies, Starbucks' financial statements are prepared by the accounting and finance departments of the company. The statements are then reviewed and approved by the company's CEO and CFO. These financial statements have both external and internal users. Externally, these statements are used by shareholders and potential investors to determine potential risk and returns when investing in the company. They are also used by the SEC to verify that what is presented on the statements is actually true. Internally, managers and higher up in the company use these statements to look at performance, compare actual to expected performance, and then develop strategies for how the company can continue to grow and increase their profits.

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

Starbuck's external auditors are Deloitte & Touche LLP and on November 18, 2013 Deloitte wrote two "opinion letters" to Starbucks. The first of these letters stated that during their audit they examined the evidence supporting the amounts and disclosures in the financial statements in accordance to with the standards of the Public Company Accounting Oversight Board. From this Deloitte concluded that consolidated financial statements present fairly, in all material respects, the financial position of Starbucks Corporation. In this first letter Deloitte also mentioned that the audited Starbucks' internal control system. Based on criteria established in Internal Control — Integrated Framework (1992) Deloitte expressed an unqualified opinion on Starbucks' internal control over financial reporting. In their second letter, Deloitte offered a contradicting opinion to their first letter. They stated that during their internal control audit they obtained an understanding of internal control over financial reporting, assessed the risk that material weakness existed and tested and evaluated the effectiveness of internal control measures. From this they determined that Starbucks maintained effective internal control over financial reporting. They later went on to say that they expressed an unqualified opinion on the financial statements of the company. To me this means that there may have been two separate groups each doing their own audit. Due to the fact that there were contradicting opinions, further review, comparing facts from both teams, would need to be done to formulate a finalized opinion. Both opinions are dated several months after the year end because it takes time to do a thorough audit after the statements have been filed.

Analysis

f. Use a spreadsheet to construct common-size income statements (which Starbucks calls statements of earnings) and balance sheets for 2013 and 2012. Common-size income statements scale each income statement line item by total net revenues (sales). Common-size balance sheets are created by dividing each figure on a given year's balance sheet by that year's total assets, thereby creating a balance sheet on a "percent of assets" basis.

	Common Sized Income Statement (In Millions Except EPS)	
Net Revenues	**September 29, 2013**	**September 30, 2012**
Company Operated Stores	79.19%	79.21%
Licensed Stores	9.136%	9.1%
CPG, Foodservice and Other	11.674%	11.69%
Total Net Revenues	100%	100%
Cost of Sales Including Occupancy Costs	42.857%	43.711%
Store Operating Expenses	28.781%	29.461%
Other Operating Expenses	3.07%	3.232%
Depreciation and Amortization Expenses	4.173%	4.138%
General and Administrative Expenses	6.298%	6.024%
Litigation Charge	18.695%	0%
Total Operating Expenses	103.873%	86.566%
Gain on Sale of Properties	0%	0%
Income from Equity Investees	1.688%	1.584%
Operating Income	-2.185%	15.019%
Interest Income and Other, net	0.83%	0.71%
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

	Common Sized Balance Sheet (In Millions)	
Assets	**September 29, 2013**	**September 30, 2012**
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%	15.1%
Prepaid Expenses and Other Current Assets	2.50%	2.39%
Deferred Income Taxes, net	2.41%	2.9%
Total Current Assets	47.51%	51.09%
Long-Term Investments	0.51%	1.41%
Equity and Cost Investments	4.31%	5.6%
Property, Plant and Equipment, net	27.79%	32.35%
Deferred Income Taxes, net	8.4%	1.18%
Other Assets	1.61%	1.76%
Other Intangible Assets	2.39%	1.75%
Goodwill	7.49%	4.86%
Total Assets	100%	100%
Liabilities		
Accounts Payable	4.27%	4.84%
Accrued Litigation Charge	24.17%	0%
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%	4.2%
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%	61.4%
Accumulated Other Comprehensive Income	0.58%	0.28%
Total Shareholders' Equity	38.9%	62.16%
Noncontrolling Interests	0.02%	0.07%
Total Equity	38.92%	62.23%
Total Liabilities & Equity	100%	100%

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

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

The accounting equation does hold for Starbucks because the total assets (11,516.7 M) equal the total liabilities (7,034.4 M) plus total equity (4,480.2 M). The is also shown on the common sized balance sheet, assets equals 100 percent and total liabilities (61.08 percent) plus total equity (38.92 percent) equals 100 percent.

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

Starbuck's major assets are PP&E (27.79 percent), cash and cash equivalents (22.36 percent), and inventory (9.65 percent). In regards to PP&E, this seems appropriate for Starbucks because they own and operate a large number of stores which house a lot of high grade specialty equipment required to brew the different drinks. In regards to cash and inventory, this seems appropriate since Starbucks is a high volume retailer. This means there is a lot of cash coming in and large amounts of inventory are required to meet the needs of their customers and franchise store owners. In 2013, short term assets account for 47.51 percent of total assets and long term assets account for the other 52.49 percent of total assets. This shows that Starbucks has enough capital and is liquid enough to cover any current obligations.

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

Intangible assets are assets that are not physical in nature but still add value to the company. Examples of intangible assets are goodwill, brand recognition and intellectual property such as patents, trademarks, and copyrights. Goodwill is one of these intangible assets and is generated when a company acquires another business. The amount of goodwill is the cost to purchase the business minus the fair market value of the tangible assets and the liabilities obtained in the purchase. Starbucks' intangible assets are composed primarily of goodwill, trademarks on their products, and the strong recognition of their brand name which is associated with high quality products.

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

Starbucks is primarily financed through debt, not equity. In 2013 total liabilities were $7,034.4 M which is roughly 1.5 times the $4,482.3 M in equity. That $7,034.4 M of liabilities to non-owners provided 61percent of the capital required for total assets while shareholders only accounted for 39 percent of financing for total assets.

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

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

Starbucks utilizes both cash based and accrual accounting when recognizing different forms of revenue. Revenue is recognized when payment is received at the point of sale at company owned stores (cash based accounting). With licensed stores, revenue is recognized at the point of shipment of the raw goods with shipping costs deducted from it. When it comes to store value cards (gift cards) Starbucks recognizes revenue when they are redeemed or when likelihood of redemption seems low, not when the gift cards are sold. At the point of sale of a gift card the cash is recorded as unearned revenue on Starbucks' books. One challenge in recognizing revenue that I observed is that Starbucks had 33 million in unearned revenue at the end of 2013. Since a management has to estimate when gift card amounts become unlikely to be redeemed, this could cause an inconsistency in revenue recognition depending on who is making the call. As a result, I would recommend that Starbucks develop a policy to recognize any unearned revenue from sale of a gift card one year after the purchase date.

ii. What are Starbucks' major expenses?

Starbucks' major expenses in 2013 came from cost of sales including occupancy costs (43 percent of net revenue) and store operating expenses (29 percent of net revenue). These expenses shouldn't fluctuate much from year to year and will increase as Starbucks grows in size. In 2013 Starbucks also had a litigation expense that accounted for about 18.7 percent of revenue. This is a large expense, but Starbucks most likely won't incur it regularly in the future.

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

During 2013 revenues increased by $1.6 billion from 2012. Even though this is the case, expenses increased at about the same rate during this time period. This is shown by the fact that on the common sized balance sheet expense accounts represent nearly the same percentage of net revenues across the two years (Example shown below). Due to this proportional growth in revenue and expense, the only change in cost structure was due to the litigation charge which severely cut into company profits.

	2013	2012
Cost of Sales Including Occupancy Costs ($)	$6,382.2 million	$5,813.3 million
Cost of Sales Including Occupancy Costs (%)	42.857%	43.711%

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

Starbucks did not include the litigation expense within the line item for general and administrative expenses because it is an irregular item. As a result, the litigation expense must be disclosed separately in the financial statements and a note must be made about it. The litigation expense is classified as an operating expense because it came about due to central activities of the business and would not fall under either the financing or investing categories.

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

In my opinion for a company to be considered "profitable", they must generate more revenue than they have expenses and not be continuously issuing debt. In order to determine Starbucks' profitability during 2012 and 2013 I looked at the company's profit margin (Net Income / Net Revenue). A good profit margin for a company is in the 10-20 percent range. In 2012 Starbucks had a profit margin of 10.4 percent ($1,383.80 M / $13,299.50 M). In 2013 Starbucks' profit margin dropped drastically to 0.06 percent ($8.3 M / $14,892 M), primarily due to the litigation expense. Even though Starbucks' profit margin dropped drastically in 2013, the company was still able to make a profit while incurring a sizable irregular expense.

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

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

Net earnings are the total profit that a company makes after expenses. Net cash provided by operating activities is the amount of cash spent and received during central and ongoing operations of the business. Net earnings is calculated by taking total revenue and subtracting cost of sales, operational expenses, depreciation, amortization, interest and taxes. From the consolidated statement of earnings, net earnings in 2013 were $8.8M while operating income was $-325.4M. This large difference occurred because net earnings is being shown net of the $238.7 tax deferral Starbucks gets in order to offset the litigation expense.

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

During 2013, Starbucks used $1,151.2 M to pay for additions to property, plant and equipment. This represents a 34 percent increase from 2012 and a 116 percent increase in what was spent from 2011.

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

During 2013, Starbucks paid $628.9 M in cash dividends and declared $668.6 M. This means that Starbucks is still liable for the $39.7 M difference.

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

Based on notes to the financial statements, there are multiple accounts that require Starbucks management to make estimates about their evaluation. These estimations can have large effects on both the balance sheet and income statement. Examples of accounts that require estimates include estimates for assets and goodwill impairments, stock-based compensation forfeiture rates, future asset retirement obligations, inventory reserves, self-insurance reserves and income on unredeemed gift cards. On the other hand, accounts such as cash and cash equivalents, accounts receivable, and certain expense accounts can be viewed as estimate free because they are based on explicitly stated values.

Conclusion

After learning about the Starbucks and reviewing their financial statements, I gained a lot of new knowledge on how to do an in depth analysis and determine the different factors that can effect a company's financial statements. Learning how to create common sized statements was very helpful with this process because it makes it easier to compare what portion something is to the whole in current and prior years. There were two main things that really stood out to me after completing this case. First, I didn't realize how many estimates went into calculating how much revenue a company actually realizes. In regards to Starbucks, this pertains to the amount of unearned revenue they recognize each year from the sale of gift cards. If Starbucks was having a bad year they could easily utilize this to make it seem like they have more of a profit than they actually did. To me this emphasizes the importance of setting up standards within an origination and acting ethically. The other thing that I was surprised by was how much of an effect one irregular expense can have on the financials and the resulting tax effect. If you are an investor it is very important to really look at the causes behind a major change in earnings of a company before making a decision on whether or not to invest.

Case 8: Contingencies - BP

Daniel Cooper Hoskins

April 2, 2019

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Introduction

The BP oil spill in 2010 was one of the largest catastrophes to occur during my lifetime. The spill had a major effect on not only the environment but on the lives of individuals and business that call the gulf area their home. Even 9 years later, this oil spill is still affecting these people and payment from all the lawsuits that occurred as a result is not yet over. This case analysis, I will first give a general overview of what a contingent liability is and how they are recorded on the books in financial accounting. Next, I will discuss the difference between the contingent liabilities that BP experienced as a result of the oil spill and the judgement management needs to take into consideration when estimating them compared to contingent liabilities associated with sales warranties. Finally, I will discuss what type of estimates I believe BP should have made in regards to the contingent liabilities and what I would do if I was an auditor involved in the situation.

Concepts

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

A contingent liability is a potential liability that may occur depending on the outcome of a future event. A company would record a contingent liability (i.e. a contingent loss) on its books if the contingency is likely to occur and the amount of the liability can be reasonably estimated. The liability may be disclosed in a footnote on the financial statements or not reported if both of these conditions are not met. Some examples of possible contingent liabilities include the outcome of a lawsuit, a government investigation, the threat of exploration, and warranties.

A contingent asset is a potential asset associated with a contingent gain. Unlike with contingent liabilities and losses, contingent assets and gains are not recorded even when they are probable and estimable. A company has to wait to report the contingent asset and gain until they are realized. Until the gain is realized, the most a company could do is make a note in their financials saying that it is likely that an event resulting in a gain will occur.

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

From BP's perspective as the purchaser of the telescope joint, the two year product warranty acts as a guarantee against any defects that might occur with the product. If a defect were to occur with this product, GE Oil and Gas would be obligated to either provide BP with a replacement part or reimbursement in the form of a credit or a refund.

From the perspective of GE Oil and Gas, the manufacturer of the telescopic joint, this two year assurance warranty (this is an assurance warranty because the warranty is included in the sales price of the part) is a contingent liability. GE Oil and Gas may either have to repair or replace some of the products they sold, thus cutting into their profits, or the warranty could never be exercised by the purchaser of the product. Companies can typically predict the number of defects and total warranty cost based on past experiences. In order to properly match revenues with expenses, GE Oil and Gas would debit Warranty Expense and credit Estimated Warranty Payable when the goods are purchased. This will be used as a reserve to pull actually warranty expense out at a later date when they incurred. If the warranty is actually realized then GE Oil and Gas would debit Estimated Warranty Payable and credit Cash, Labor, or Parts. If at the end of the period there are amounts remaining, the original entry would be reversed by the original amount or the amount remaining.

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

When it comes to contingent liabilities, management needs to take a serious look at the probability of the lost being realized. If the loss is likely to be realized and the amount of the loss is estimable, then management needs to realize the loss on the books. When it comes to accrued warranty costs, management needs to establish an Estimated Warranty Payable account and add the estimated cost to it after each sale of a product with a warranty. Than management needs to keep track of the timing of warranties and amortize off the difference between the predicted expenses and the expenses actually incurred.

The main difference between a claim for damages resulting from the Deepwater Horizon oil spill and a warranty claim on a piece of equipment is that warranty claims are expected and the amount can be reasonably predicted. The number of potential claims on warranties is also limited to the number of products sold. On the other hand, events such as the oil spill are completely unexpected and the impacts were very unique to the situation. With the oil spill claims could also come from a variety of different sources that were negatively impacted. This ranges from medical claims from victims, claims from people on the coast whose businesses were negatively impacted, and fines paid to environmental agencies. All of these claims were not anticipated by BP and the magnitude of them even after the event occurred was still hard for BP to predict. There are even still claims today that have not been paid out to victims.

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

Accountants at BP had to make a wide variety of estimates to account for the numerous contingent liabilities that arose from their role with the Deepwater Horizon Oil Spill. When the disaster occurred BP estimated a total of $37.2 billion in losses. The total losses BP has incurred to date are around $65 billion and even though this disaster occurred in 2010 payments are finally just starting to slow down.

These estimated contingent liabilities came from a wide variety of sources. Accounts would first have to estimate for the suits from the families of the 11 workers that died during the incident. Suits could also come from people who lived on the gulf coast who were personally damaged, tourist and fishing businesses on the coast that lost business due the oil spill, and the different states that border the gulf and lost money due to the spill. BP accountants would also have to estimate contingent liabilities from fines they would receive from government agencies such as the EPA who had to help deal with the aftermath. At the time these fines would be hard to estimate because the penalty will most likely be very high in order to promote other oil companies who drill offshore to take another look at their practices and procedures in order to prevent this catastrophe from happening again. Also the fines would continue for a long period of time because this spill will have a large effect on the environment in and around the Gulf of Mexico for many years to come.

d part 2. If you were the auditor for BP working with lawyers creating a contingent liability accrual, how would you draw boundaries around the potential impacts and size of the suit? If you were on the audit team how would you decide if an accrual is reasonable? Should they be booking more or less?

If I was the auditor, I would draw boundaries by first creating by limiting the number of categories in which people could file suits against the company. These categories could include fines from government agencies, claims from individuals, claims from states, claims from businesses, and claims from the families of the 11 people who died in the accident. I would then set up a fund that could be drawn from in order to pay for the fines and claims against the company. The amount in this fund to start off would be a portion of expected contingent liabilities from each category and then it would be added to as claims are paid off and the estimated future contingent liabilities change. Since the value of all of these contingent losses is hard to predict I would look at similar past cases to determine if the accrual was reasonable and book these contingent liabilities as if it was any other contingent liability. They would be booked when the probability of them being realized is probable and estimable.

Conclusion

This case study put into perspective that when it comes to contingent liabilities, there is a significant amount of gray area. When it comes to irregular events, such as the BP oil spill, there are a lot of estimates and judgment calls that have to be made by management in determining how much of a loss to plan for and when to realize certain portions of that loss. In addition to all the money lost due to the BP oil spill, the company had to pay a large fee to all the accountants that managed the contingent liabilities. These accountants had the tough task of trying to balance GAAP requirements while still trying to defer as many claims as possible. After doing this case, I have determined that regardless of the situation as accountants we need to follow GAAP standards. This means to the best of our abilities realizing losses from contingent liabilities when they are both probable and reasonably estimable.

Case 9: Equity Method Investments

The Wendy's Company

Daniel Cooper Hoskins

April 10, 2019

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Introduction

In this case, I took an in depth look at the effects of using the equity method to account for investments. Specifically, I examined the TimWen joint venture between Wendy's and Tim Hortons and combed through their consolidated financial statements. First, I will talk about why companies do joint ventures and what exactly the equity method of accounting is. After this, I will discuss what Wendy's was forced to do as a result of their investment amount exceeding their share of the book value. Finally, I will cover where to look on the financial statements to find amounts related to the equity investment, how the equity method affects earnings before taxes, and how to do both the regular and adjusting entries associated with the equity method of accounting.

Concepts

a. In general why do companies do joint-venture agreements?

A joint venture is when two companies to pull together their resources and expertise in order to develop a good or service that generates profit for both parties. In this particular case, I will be looking at a 50-50 joint venture between Wendy's and Tim Hortons Inc. This Canadian restaurant real estate joint venture called "TimWen" owns and operates 105 Wendy's/Tim Hortons combo restaurants in Canada.

A major advantage of joint ventures is that it can help both businesses grow faster, which in turn leads to higher profits. This venture could increase capacity and give both businesses access to new markets, distribution networks, and resources. Both companies would also now be sharing the risks and costs associated with opening all of these new restaurants. On the other hand , there are some possible disadvantages. Before committing to a joint venture, management on both sides needs to ensure that both companies share the same objectives and visions and are both fully committed. Throughout the process there also needs to be constant communication, especially when there is an issue.

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 for accounting for investments is used when one company has significant influence over another, typically holding between 20 and 50 percent of its stock. This power results in representation on the board of directors, participation in polity development, and influence in selecting managerial personnel. When the equity method is used, the investor records the initial investment at cost. Subsequently, the carrying value of the investment is adjusted each period to reflect the investor's share of income or loss. When the investee earns money, the investor records its proportional share of the earnings as revenue from the investment and increases the investment's carrying value. This is done with a debit to the investment account and a credit to investment revenue. When the investee reports a loss, the investor reduces the carrying value of the investment with a debit to investment income and a credit to equity investment. If the investor receives dividends from the investee, under the equity method the investor reduces the carrying value of the investment by the amount of dividends received. This is done with a debit to cash and a credit to the investment account. Finally, with the equity method investors always report the carrying value of their investment independent of any fair value changes.

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?

Under the equity method, the investing company accounts for this excess amount paid over their share of the book value of the underlying net assets of the investee as an accounting acquisition premium. For example, if a company pays $1 million for a company and their book value is $600 thousand (investee's assets minus liabilities or equity section) then the accounting acquisition premium is $400 thousand. The investor then writes up identifiable assets and liabilities to fair value using amounts in this premium. If the fair value of the assets in the example mentioned above was $800 thousand, then the assets and liabilities would be written up by a total of $200 thousand and there would be $200 thousand of accounting acquisition premium left. In addition, there is an annual charge to the parent company to account for the depreciation on the $200 thousand the equity investment account is written up. The $200 thousand remaining of the premium is then allocated to goodwill which is tested annually for impairments. If goodwill is impaired a loss is recognized. This is the only case where goodwill would influence the investor's net income.

Process

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?

On its 2011 and 2012 balance sheet, Wendy's recorded equity method investments for their joint venture with Tim Hortons and for their joint venture in Japan. In 2011 the total was $91,819 thousand and in 2012 it was $87,620 thousand. These numbers appear on Wendy's consolidated balance sheet in the "assets" section under the title "investments". In 2012, the equity investment loss from the Japan join venture was included in "Other liabilities". This is because they have agreed to finance anticipated future cash requirements since the business either lost money or paid out more in dividends than the equity investment was worth.

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?

At the year-end 2012, the amount recorded for Wendy's equity investment in the TimWen joint venture is $89,370 thousand. The "partner's equity" reported in the TimWen portion of the consolidated balance sheet is listed as $70,565 for 2012. Based on the fact the Wendy's has a 50% share in the venture, only $35,282.5 thousand of the $70,565 thousand is considered Wendy's equity. The difference between Wendy's share of the equity ($35,282.5 thousand) and what they report the equity investment at ($89,370 thousand) is Wendy's accounting acquisition premium ($54,087.5 thousand).

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

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

Since Wendy's used the equity method to account for their investment in TimWen, Wendy's recorded their proportionate share of TimWen's earnings and the amortization of the purchase price premium. The amortization of the purchase price premium will reduce total earnings before tax by $2,934 thousand in 2011 and $3,129 thousand in 2012. The adjustments to currency fluctuations and dividends would not affect this number because under the equity method they do not flow through income. For 2011, Wendy's earnings before taxes is $10,571 thousand. This is calculated by taking the value of the equity investment ($13,505 thousand) minus the amortization loss ($2,934 thousand). For 2012, Wendy's earnings before taxes is $10,551 which is calculated again by taking the value of the equity investment ($13,680 thousand) minus the loss on investment due to the amortization of the purchase price ($3,129 thousand). These numbers appear on the consolidated income statement under "amortization of purchase price adjustment" and the subtotal below. They offset expenses in "Other operating expenses, net" in the "cost and expenses" section.

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

2012: Equity Investment (TimWen)	10,551,000	
Equity Investment Income		10,551,000

This number is calculated by taking the $13,680 thousand under "Equity in earnings for the period" in Note 8 and subtracting the $3,129 thousand amortization of the purchase price adjustment.

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

In 2012, the amount of the amortization of the purchase price adjustment $3,129 thousand. This is shown as "Amortization of purchase price adjustments" on Note 8 of the consolidated income statement. This 21 year amortized premium gradually decreases the value of the equity investment from what was paid to the book value of Tim Horton's assets on their balance sheet. By gradually deducting the premium on the purchase price from net income each year as a loss over the entire life of the investment the entire loss doesn't hit the books all at once at the time of purchase.

2012: Loss on Equity Investment	3,129,000	
Equity Investment (TimWen)		3,129,000

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

In 2011 Wendy's received $14,942 thousand in dividends from the TimWen joint venture and in 2012 they received $15,274 thousand.

2011: Cash		14,942,000	
	Equity Investment (TimWen)		14,942,000
2012: Cash		15,274,000	
	Equity Investment (TimWen)		15,274,000

In these entries we debit cash and credit equity investment because according to the equity method of accounting, dividends received by the investor decrease the carrying value of the investment.

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

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

As determined earlier, using the equity method of accounting for the TimWen investment resulted in a $10,551 thousand effect on net income. But, this value is from a noncash transaction, so a negative adjustment of $8,724 thousand for "Equity in earnings in joint ventures, net" is made to reduce net income. The adjustment of $8,724 thousand is the net of the positive income effect from the TimWen joint venture less the "Equity in losses for the period" from the joint venture in Japan of $1,827.

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

The reported positive adjustment for "Distributions received from joint venture" of $15,274 thousand in 2012 made to "Cash flows from operating activities" represents the cash dividends received from the TimWen joint venture. This cash did not originally flow through income because when the dividends were received a credit to the equity investment was made to reduce the carrying value. As a result, we must make the adjustment to the revenue account to accurately reflect the amount of cash on hand. The $15,274 is the same as the value listed under "Distributions received" in Note 8 from the TimWen joint venture.

Conclusion

Prior to doing this case, I felt like I had a good understanding of the equity method of accounting for investments. But as I worked through it, I realized there were quite a few aspects of equity method accounting that I have never been exposed to. In all of my other accounting classes, we always sent any excess in purchase price over their share of the net assets directly to goodwill. I did not know about creating the accounting acquisition premium. The premium is then used to write up assets to fair value and the remainder is sent to goodwill. Going along with this, over time the premium is them amortized off with a purchase price adjustment so that the entire loss does not hit the books all at once. In addition before doing this case I knew that dividends received by an investor are recorded as a debit to cash and a credit to reduce the carrying value of the investment. I did not realize that an adjustment needed to be made to revenue to accurately reflect the amount of cash on hand from the dividends. Overall, after doing this case I feel very comfortable with the equity method and understand all of the different parts that come into play when using it to account for an investment.

Case 10: Retirement Obligations

Johnson & Johnson

Daniel Cooper Hoskins

April 18, 2019

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Introduction

In this case I will give an overview of how to properly account for defined benefit pension plans by looking at the retirement obligations of Johnson & Johnson. First, I will talk about the difference between the two general types of retirement plans (defined contribution and defined benefit), what activities influence a company's pension obligations and assets, the return on plan assets component of pension expense and plan assets, and how accounting for pensions differs from accounting for other employer provided benefits. After this I will look at Johnson & Johnson's financial statements and discuss their pension expense, retirement plan obligation, pension related interest, and how much they paid out to retirees. Finally, I will discuss the value of their retirement plan assets, their expected return versus actual return, the types of investments that make up their plan assets, and whether or not their retirement plan is over or under funded.

Concepts

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

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

In a defined benefit plan, benefits received by an employee upon retirement are determined by the number of years the employee works and their highest salary levels. As a result, employer contribution paid out after retirement varies. This makes it hard to predict the exact amount that will have to be paid out in the future and the risk is borne by the employer. With a defined contribution plan, each period the employer agrees to contribute a fixed amount to the plan. In this case the risk is borne by the employee and benefits received upon retirement are based on the total value of the plan. Johnson & Johnson has mostly defined benefit plans, but some employees have defined contribution plans.

ii. Explain why retirement plan obligations are liabilities.

Retirement plan obligations are liabilities because they are a form of compensation paid to employees. As long as the employee performs their duties, the company is either required to pay their portion of the defined contribution plan now (current liability) or the defined benefit plan in the future (long term liability).

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

Some of the assumption that are necessary in order to account for the retirement plan obligations of defined benefit plans are how long the employee will work, what their highest salary levels will be, when they will retire, and how long they will live after retirement (how many years benefits will have to be paid out).

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.

Service cost is the actuarial present value of benefits attributed by the pension benefit formula to employee service during the current period. Interest cost is the interest for the period on the projected benefit obligation outstanding. The interest rate used is referred to as the settlement rate. Both the service cost and interest cost increase the companies' pension obligation. Actuarial gains or losses result from the difference between the pension payments actually made during the period by the employer and the expected amount to be paid out. These expected amounts are derived from actuaries' predictions about future salaries, length of employment, and mortality rates. Finally, benefits paid to retirees refers to the amount of benefits actually paid out to retirees during the period and reduced the overall pension obligation.

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.

Actual return on pension investments is an increase in a company's pension assets from interest, dividends, and realized and unrealized changes in the fair value of the plan assets. It is calculated by the following formula: Actual Return = (Plan Assets Ending Balance – Plan Assets Beginning Balance) – (Contributions – Benefits Paid). Company contributions also increase the value of pension assets and are new amounts paid into or invested in the fund during the period. Finally, benefits paid to retirees refers to the amount of benefits actually paid out to retirees during the period and reduced the overall value of the companies' pension assets.

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.

A companies' pension expense and pension plan assets are both affected by the return on plan assets. Return on plan assets is an increase in pension funds from interest, dividends, and realized and unrealized changes in the fair value of plan assets. This return reduces the pension expense for the period while at the same time increasing the total value of the pension plan assets. There may be an adjustment if the expected return at the beginning of the period is different than the actual return at the end of the period.

e. Johnson & Johnson provides other benefits to retirees including health-care and insurance benefits. What is the primary difference between the company's other-benefits plans and its retirement plans?

The primary difference between Johnson & Johnson's other benefits plans, such as health-care and insurance, and retirement plans is that the other benefits plans are not funded in advance. These plans are part of the employee's compensation, expensed every period, and are a specific amount determined by the employer that can be modified over time. The defined benefit plans offered by the company are long term liabilities because they are amounts that will have to be paid out in the future after the employee retires. The amount of compensation also varies because it depends on the number of years the employee works and their highest pay levels. This makes predicting the exact amount of the future expense very difficult.

Process

f. Consider Johnson & Johnson’s pension expense detailed on page 61 of the company’s annual report. Note that the company uses the term “net periodic benefit cost” to refer to pension expense.

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

Johnson & Johnson reported $646 million in pension expense on its 2007 income statement. This amount is listed under the title “Net periodic benefit cost” on page 61 of the company’s annual report.

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

Pension Expense	1,253 million	
Projected Benefit Obligation – Service Cost		597 million
Projected Benefit Obligation – Interest Cost		656 million

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

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

On December 31, 2017, the value of Johnson & Johnson's retirement plan obligation was $12,002 million. This value represents the current amount the company predicts they will have to pay out to employees after retirement. This number is pretty reliable, but it is based off actuarial predictions. As a result, the amount actually paid out could end up being more or less than this number. But, with decent certainly, this number is good estimate of the amount that will have to be paid out based on current conditions and future factors that cannot be determined with 100% confidence.

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

Johnson & Johnson's pension-related interest cost for 2017 was $656 million. The average interest rate Johnson & Johnson used to calculate interest cost during 2007 was 5.62%. This rate is calculated by dividing that interest cost for the year ($656 million) by the projected benefit obligation at the beginning of the year ($11,660 million). This rate does seem reasonable because it is in between the international benefit plans discount rate of 5.5% and the U.S. benefit 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?

During 2007, $481 million in pension benefits were paid to retirees. Johnson & Johnson did not pay cash for these benefits; they used their retirement plan assets. When these benefits are paid, the retirement plan obligation account is debited and reduced and the retirement plan assets account is credited and reduced.

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

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

On December 31, 2007, the value of the retirement plan assets held by Johnson & Johnson is $10,469 million. This value represents the fair value of all the investments and contributions that the company has made to pay out future retirement benefit obligations.

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?

During 2006, Johnson & Johnson's expected return on plan assets was $701 million and their actual return was $966 million. Since the actual return in 2006 was greater than the expected return this results in an asset gain of $265 million. During 2007 the expected return was $809 million and the actual return was $743 million. Since the actual return this year was less than the expected return there is an asset loss of $66 million. Companies record these asset gains and losses in other comprehensive income. When determining whether or not these differences were significant we need to look at the 10% corridor approach. In 2016 the difference was roughly 27.5% meaning that it is significant and the amount of gain above 10% needs to be amortized. In 2007 the difference was only 8% so it is deemed insignificant. The actual return on plan assets better reflects the economies of the company's pension expense because it is the return that actually occurred. The expected return is just a prediction.

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.)

During 2007, Johnson & Johnson contributed $317 million to the retirement plan and their employees contributed $62 million. Both of these numbers increased from the contributions made in 2006. In 2006, Johnson & Johnson contributed $259 million to the plan and their employees contributed $47 million.

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

In 2007, Johnson & Johnson's U.S. retirement plan assets were made up of 79% equity securities and 21% debt securities. The company's international retirement plans in 2007 were made up of 67% equity securities, 32% debt securities, and 1% real estate and other investments.

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

In both 2006 and 2007 Johnson & Johnson's retirement plan was underfunded. In 2016 the plan was underfunded by $2,122 million and in 2007 it was underfunded by $1,533 million. Even though in both years the plan was underfunded, it is good to see that from 2006 to 2007 the amount the plan was underfunded decreased rather than increased. This funded status appears in the "Funded status at – end of year" line under then "Change in Plan Assets" section of the balance sheet. We know the plan is underfunded because the amounts in this line are negative.

Conclusion

This case really highlighted the complexity of accounting for defined benefit pension plans. Defined benefit plans create long term liabilities and involve a lot of estimates. Because there obligations are so far into the future and it is hard to predict how much money will be needed to pay out all of a company's retirement benefits, it would be easy for a company's plan to become underfunded, as in the case with Johnson & Johnson. As a result, I feel like in the future companies need to start to phase out offering defined benefit plans to employees and switch exclusively to defined contribution plans.

Case 11:

Balance Sheet Based Model of Financial Reporting

Columbia Business School

Columbia Business School
Center for Excellence in Accounting and Security Analysis

Daniel Cooper Hoskins

April 26, 2019

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Question 1: Summary

The FASB and the IASB are currently re-considering their Conceptual Framework that was adopted about 30 years ago. This article from the Center for Excellence in Accounting and Security Analysis at the Columbia Business School argues that the balance sheet orientation of accounting standard-setting is flawed for multiple reasons. First, accounting is supposed to reflect business reality. The balance sheet orientation of financial reporting is at odds with the economic process of advancing expanses to earn revenues. This governs how businesses create value and how managers and investors view firms. Secondly, the concept of income is clearer and practically more useful than the concept of assets. Thirdly, earnings is the most important output of accounting and the continual expansion of the balance sheet approach is gradually destroying the forward-looking usefulness of earnings through the effect of asset revaluations. Finally, the balance sheet approach has pushed accounting into involving more valuation estimates in financial reports. In order to remedy these issues, this paper suggests that accounting needs to make a distinction between operating and financing type activities and assets. Also at most firms, the accounting for operating activities needs a renewed emphasis on the principle of matching expenses to revenues.

Currently, the FASB's reconsideration of the conceptual framework doesn't include a re-assessment of the balance sheet orientation of accounting. The income statement approach to accounting is the natural foundation for financial reporting for most firms. By disregarding this approach and focusing on the balance sheet approach this is bound to result in faulty accounting, no matter what desirable characteristics the rest of the financial reporting model might have.

The main difference between the balance sheet and the income statement approach is that the balance sheet approach views the proper valuation of assets and liabilities as the primary goal of financial reporting with the determination of other variables considered secondary and derivative. The determination of income statement amounts, especially earnings, is governed by balance sheet considerations. Earnings for a given period are just the change in net assets over the period. The income statement approach views the determination of revenues, expenses, and earnings as the primary goal with an emphasis is on the timing and magnitude of revenue and expense amounts. The major guiding principles with this approach are the revenue recognition principle and matching or expenses to revenues. The goal of accounting is to record accruals. Balance sheet amounts and accounts are mostly the residual of this process and assets and liabilities are the cumulative effect of periodic accruals. The income statement approach is supported by the investment community because with this approach stock value arises from the firm's ability to generate a stream of earnings rather than the residual value of assets.

The FASB realized that the income statement and balance sheet approaches are two major alternatives and to ensure clarity and consistency one had to be chosen. In the late 1970's, the board concluded that the balance sheet approach was the better option and should become the cornerstone of standard setting moving forward. The main reason for this choice was earnings being a change in value. It is impossible to define change in value without defining value and thus the determination of assets and liabilities logically supersedes the determination of earnings. The income statement approach relies of vague concepts like matching resulting in accruals and deferrals which creates assets and liabilities of questionable substance. Recently, the FASB has been adopting more forms of the balance sheet approach with the initiative for moving to "fair value” accounting. This approach uses market prices as a benchmark for value for company accounting.

In 2006 the FASB issued a document called Preliminary Views. This document presented a strong endorsement for the balance sheet model and deteriorated the status of the income statement and earnings in particular. The document doesn’t use terms such as “revenues”, “expenses”, “earnings”, and “income” and instead prefers terms that are variations on “changes in economic resources and claims to them”. Even though the FASB’s framework has always had somewhat of a duel nature emphasizing the importance of both balance sheet accounting and earnings in financial reporting, the implication is that now standard setters view earnings as much less important than before.

One of the main problems with the balance sheet approach is that it is at odds with how most businesses operate, create value, and are managed. Most firms are continually advance expenses to earn revenues. As a result, most assets are just supplementary and temporary devices that serve the continual stream of company operations and have little independent existence and value. The balance sheet approach would make sense if the primary mission of the firm is to earn money by acquiring assets, storing and growing them and earnings represents the realized or unrealized growth in these assets. But, most firms are not like this and assets are continually sacrificed or transformed for the larger goal of producing revenue and earnings. The balance sheet approach makes it look like there is a permanent store of assets. But, what really matters is the expenses advanced and the revenues and profits ultimately earned. Assets are just temporary implements to carry business that act in a secondary supporting role. As a result, proper accounting needs to reflect this reality.

Managers manage their business following the income statement approach. They prepare a budgeted income statement and then after that think about the asset base necessary to support the predictions and the financing needed to make everything happen. This also applies to managerial decisions like opening a new product like or starting a new division. They think about the operating and investment costs to get the project going, revenues that will likely be earned, and whether the resulting return on investment is acceptable. The build-up of assets in a new division is not viewed as a source of added value.

Investors are the most important users of financial reporting information and base their decisions on income statement considerations. Analysts' projections of balance sheet amounts are rare, and one never sees a projection of balance sheet amounts as a means to compute changes in net assets, which will comprise earnings. The balance sheet model takes asset values as stores of value, which are completely divorced from what the firm is doing, and diverts attention from operations, which are key to firm success and value. On the other hand, the income statement model by nature focuses attention on firm operations and on the fact that firm value arises not from a static pile of resources, but from continually using and putting these resources at risk. Business success under the income statement model is determined by real operations and the value of resources comes from value-in use and not value in exchange.

The amount of sales of PPE is small compared to the amount of depreciation. The use of PPE for internal purposes exceeds the use of PPE for external purposes by 5 to 10 times. Sales of PPE are also only 1-2.5% compared to the level of PPE. As a result the fir values of PPE on the balance sheet are irrelevant for 98-99% of the assets. If one revises the value of all assets, and this revision flows through the income statement, this creates great volatility in earnings.

PPE accounting has to be primarily concerned with the internal use of PPE, and much less with the fluctuations of PPE value which makes the income statement method of accounting better.

The main difference between income statement oriented operations and balance sheet oriented operations is the distinction between operating and financing activities. For financing assets and liabilities that a firm holds the balance sheet approach makes sense. The balance sheet approach is inappropriate for operating activities where assets have little independent existence and therefor little independent separable value. As a result, for most firms and activities, the income statement approach seems the best fit for evaluating value creation.

The FASB considers the concept of assets as the most important part of accounting and all other concepts are derived from it. They define assets as "probable future economic benefits obtained or controlled by a particular entity as a result of transactions or events". This definition implies that an asset is something that will bring future benefits which sounds a lot like earnings. The concept of asset and income are connected, for every dollar of income there must be some sort of asset producing it. By using the balance sheet method of accounting the FASB suggests that the two concepts can be divorced and one made superior to the other.

When companies are extraordinarily profitable, you can infer that there must be some missing assets which can be called intangibles, goodwill, human capital, monopoly position, or captive customer basis. Most of these assets are exclusively conceptual and difficult to operationalize in any helpful way. With balance sheet based accounting these play a huge role when in fact the valuation of intangible assets is derivative and conditional rather than fundamental.

The bulk of changes in the properties of earnings are due to changes in the accounting rather than due to changes in the real economy. The changes in the properties of earnings happen because the balance sheet approach mandates various asset revaluations. This increases the magnitude of write offs and one time charges which increases the volatility of earnings and weakens the relation between stock price and earnings. This means that current earnings tell you less about future earnings. This could also lead to erosion of the accounting profession, people will begin to turn to non-GAAP metrics of value, and there will be further stratification between sophisticated and unsophisticated investors.

The end of the article makes numerous suggestions about what a “better” conceptual framework might look like. First, a better conceptual framework would have a clear theoretical and practical difference between operating and financing activities. The income statement needs to clearly identify the difference between earnings from regular operating activities, which have a lot of persistence and forward looking informative ability, and earnings due to value fluctuations in financial assets, which have little persistence and predictive power. As a result, accounting will have to move away from the notion of a single bottom line. Secondly, financial reporting should have a renewed emphasis on the matching principle and to a lesser extent the revenue recognition principle. The matching principle is important because the goal is to make accounting reflect and follow the economic logic of the business as much as possible by matching costs with benefits. It also makes the cost benefit considerations that every business uses more reliable. If accounting aims to be a faithful representation of business, its core principles should reflect the core drivers of business.

Question 2:

How did reading this article change my current way of thinking?

In my opinion the goal of a company is to act legally and ethically and generate revenue so that they can pay out employees and investors and continue to grow the business. A company should as make sure that they have their investor's best interests in mind and that they do whatever they can to attract new investors. Currently, I invest some of my money in mutual funds and dabble in the stock market. Most of my individual stock investments though are in very secure companies that have an established place in the market. Reading this article honestly kind for made me a little confused and mad. Many young investors are not accounting majors and would rely on numbers they see on the financial statements of companies to determine whether or not they wanted to invest. As a result of many of these companies using the balance sheet method of accounting, the earnings numbers be propped up on assets and not be truly representative of how the company is actually performing. This could be very misleading to new investors or young people looking to grown their money in the stock market.

Using the balance sheet method of accounting causes current earnings numbers to be less representative of future earnings. As a result, before I invest in my next company I will really dive into the company's financial statements and see if they are actually generating money from selling products or providing services. In one sense it makes me happy that being an accountant I will know how to look for these indicators so that I can make smart investments. On the other hand this is creating an even bigger divide between sophisticated and unsophisticated investors. I believe that it is important as a company to present information so that everyone can see how business is truly going and decide whether or not to invest.

Question 3:

How will you use this information in your future career?

Even though I am an accounting major and have been studying the subject for the last few years, reading this article really opened my eyes to the fact that even after I am done with school the learning process will never end. I know that with any job there is a learning curve associated with figuring out how business is run in that specific office and how to use their software and tools to do the job. But, as we are being taught current accounting principles and standards in the various classes I have taken and will take in the future, I did not think about the fact that those principles could change and I would have to relearn the fundamentals behind my job. This means that while I am out in the workforce I will constantly have to stay up to date and read so that when a change comes I can learn about it as fast as possible, apply it right away, and show my superiors that I work hard and I am a high performer. In relation to this I am very happy that my current professors are willing to adapt to these new standards and teach us them while I am still in school. Learning the new tax code and leasing standard will be very helpful as I prepare for the CPA exam and my career as an accountant.

At this point in time I can see myself going in multiple different directions with my career. First, I could see myself either working on a deal advisory or audit team at a public accounting firm. When it comes to deal advisory, it is important to give clients an accurate assessment of the standing of the company that they are looking to purchase. If the balance sheet method of accounting is going to continue to be used, then it would be important to really dive into the financials of the company to see if assets are propping up their numbers or if they are actually generating revenue from the products they sell or the services they provide. Any company could make it appear like they are doing well under the balance sheet method of accounting if they have a bunch of very flashy and expensive equipment. But, what really matters is if based on their current situation if it looks like they are going to continue to make money doing the thing they went into business to do. In regards to auditing, the balance sheet method involves a lot of estimates about the valuation of assets. As an auditor I will need to go to clients and compare how their assets are presented on the balance sheet to the actual condition of the assets. Since the valuation of these assets plays such a big role in the earnings of a company under the balance sheet methods making sure they are accurately represented on financial statements is very important.

If I do not end up working in public accounting, I would like to work in the accounting department of a manufacturing company. Any large scale manufacturing involves high tech machinery and equipment. As a result, as long as the balance sheet method of accounting is the current accepted standard properly accounting for the depreciation on and the fair value of these assets is extremely important since they greatly influence earnings numbers. There is a lot of wiggle room with these numbers that accountants could use to make their numbers appear better than they actually are. I feel that it is important to properly represent the standing of the company to potential investors. As a result, if I was ever in a management position of a publically traded company, I would consider issuing statements under both the balance sheet and income statement methods of accounting. This would be a decent amount of extra work but I think it would pay off. Potential investors could see this as the company being very transparent about their earning and be more enticed to invest in the company.

Case 12:

Earnings Announcements & Information Environment

Google Inc.

Daniel Cooper Hoskins

May 3, 2019

Table of Contents

Introduction

In this case I start by introducing what exactly a non-GAAP financial performance measure is by summarizing an article by Allan B. Afterman. In this article he talks about what they are, how they are currently treated and used by companies and financial analysts, the pros and cons of using these types of measures, and how they could possibly be improved to become more useful. After this, I go on to talk about the difference between Google's net income and the non-GAAP equivalent they reported in their January 30, 2014 press release. Next, I will go on to talk about how earnings relate to stock price and drastic effect an earnings report can have in on stock price in a very short time. I then compared Google's performance in 2013 to the NASDAQ index during that same period of time. Finally, I will discuss how Google's press release positively influenced their stock price even when most recent reported earnings were below what was projected.

Non-GAAP Performance Measures: Virtue or Vice?

By Allan B. Afterman

A non-GAAP performance financial measure is a number representing a company's historical or future financial performance, financial position, or cash flows that excludes amounts otherwise included in (or includes amounts otherwise excluded from) the most directly comparable U.S. GAAP measure. When publicly disclosed, this non-GAAP performance measure must be accompanied by both the most directly comparable GAAP measure and a reconciliation between the two amounts. It must also include a description of why management believes the non-GAAP measure is useful to investors and an explanation of the purpose for which management uses the non-GAAP measure. In regards to non-GAAP measures, Item 10(e) prohibits eliminating or smoothing items that can deemed nonrecurring, infrequent, or unusual if there has been a similar charge within the prior two years or it is likely to occur again within the next two years. While this is the case, with non-GAAP performance measures a company may make any adjustment it believes appropriate.

Non-GAAP performance measures have been around since the 1960s when they were referred to as "pro forma earnings". In 2003, the term was replaced with "non-GAAP financial measure". Companies that present non-GAAP performance metrics (EBIT, EBITDA, and Adjusted EBITDA) believe that they provide insight into a company's core operations beyond one size fits all GAAP. This way, investors can view the company through management's eyes and have a better understanding of the business. As a result, international regulators have taken the SEC's lead and chosen to allow companies the flexibility to present non-GAAP performance measures as they see fit.

Some claim that companies present non-GAAP earnings opportunistically to overturn GAAP loss, to report positive earnings growth when it is negative on GAAP basis, and to meet or beat earnings projections. This being said, the quality of non-GAAP earnings has improved with the requirement to reconcile non-GAAP metrics to the most directly comparable GAAP measure. Because non-GAAP earnings are likely to exclude transitory items, non-GAAP reported amounts tend to be better predictors of future earnings and cash flows.

Adjusted EBITDA is one of the most frequently non-GAAP performance measures presented in SEC filings and is an umbrella term. The sheer number of items subtracted from or added to net income to arrive at adjusted EBITDA reflects both the flexibility management has in arriving at is version of core earnings and the difficulty regulators face in establishing rules about the selection of items.

A major drawback is that non-GAAP measures are not comparable to those of other companies. This could also be said about pure GAAP, but this lack of comparability is a byproduct of management flexibility. Value of these metrics could be enhanced by clear explanations of the reconciling items and the rationale for including or excluding them and a discussion of how the measure is used by management.

Adjusted EBITDA would be strengthened by a uniform name because it is currently an overly general description of what it is intended to convey. The terms “core earnings” and “underlying profit” would better clarify management’s intent. In conclusion, the combination of GAAP and non-GAAP metrics represents a powerful analytics tool in understanding a company’s underlying business, but steps can be taken to clarify what these non-GAAP metrics actually mean by better distinguishing between recurring and infrequent items.

Analysis

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

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

According to GAAP, operating margin is defined as consolidated income from operations divided by consolidated revenues (page 13 note a). The non-GAAP operating margin that Google presents on its financial statements is defined as non-GAAP consolidated income from operations divided by consolidated revenues (page 13 note g). Google converts its GAAP to non-GAP consolidated income with five adjustments listed on page 13 in notes b-f. They are, to eliminate stock-based compensation expense, to eliminate restructuring and related charges, to eliminate income tax effects related to expense noted in (b), to eliminate income tax effects related to expense noted in (c), and to eliminate net loss from discontinued operations. Most of the adjustment comes from eliminating stock-based compensation by adding it back to the consolidated income amount. In 2013 this was a $902 million addition to GAAP earnings. The rationale of adding the expense back is that it was a non-cash expense that was incurred rather than being paid out as cash salaries. But while doing this, Google diluted its number of shares and negatively impacted its shareholders. As a result, I do not agree with Google’s adjustments in computing non-GAAP earnings because by using this metric Google can make its numbers appear better while the end result is a negative impact on investors.

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

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

A company's stock price is directly correlated with their earnings performance and earnings per share. In the first and second quarters Google's earnings performance was on par with that of the NASDAQ index so their share price gradually increased during this time at a similar rate. Google had its two biggest fluctuations in stock price after the third and fourth quarter earnings were released. Third quarter earnings were much higher than anticipated which resulted in the stock price shooting up. On the other hand, when fourth quarter earnings fell below analyst's predictions the stock price dropped. The stock price quickly corrected itself after the earnings press release, but this goes to show how quickly stock prices can move up and down based on earnings performance.

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

From the beginning of 2013 until October of that year, Google's stock performed similarly to the border set of firms trading on the NASDAQ exchange. As soon as third quarter earnings were released in early October, Google's cumulative stock return went up to about 40 percent (a 15 percent increase) while NASDAQ return stayed constant around 25 percent. This quick change is shown by the yellow circle on the graph below. Throughout the entire fourth quarter Google's cumulative stock return continued to climb, reaching around 65 percent, while the NASDAQ only reached 35 percent by the end of the year.

Google (*GOOG*) vs. NASDAQ Index

Upper line reflects *GOOG*, lower line reflects the NASDAQ Index
Right axis shows the cumulative stock return from January 1, 2013

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

Based on the stock market chart, the market perceived the earnings news in Google's January 30, 2014 press release as bad news at first. This can be seen in the graphic below by the sharp drop in the stock price at the beginning of February from around 1.18K to 1.13K (shown by the yellow circle). As shown on the prior graph, this also dropped Google's cumulative stock return from about 63 percent to 56 percent. Over the course of February, the stock price went back up and reached 1.2K which is 0.03K higher than what it was at the end of 2013. This fluctuation may have been due to the fact since third quarter earnings were so high, when the fourth quarter earnings were released they did not meet the high expectations of investors. Over a short amount of time this knee jerk reaction was corrected and the fourth quarter earnings report had a positive effect for Google.

Google Inc (Ticker: *GOOG*) Stock Charts
For the period January 1, 2013 to February 14, 2014

Right axis shows stock price

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

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

According to the Wall Street Journal article, Google's fourth quarter revenue of $16.9 billion exceeded analyst's predictions of $16.8 billion by just $0.1 billion. On the other hand, earnings per share were only $12.01 while analysts predicted them to be $12.20 per share. These relations seem to be consistent with the positive reaction following the press release. Prior to the press release, when all investors had was the underwhelming earnings report, the stock price dropped significantly. Once the press release came out it stated that even though earnings per share fell short of expectation in the fourth quarter, according to non-GAPP measures the company was actually more profitable than the earnings per share metric made it appear. As a result, investors became less worried and realized that the core operations of the business were still profitable which lead to the rebound of the stock price.

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

Some of the other factor that the article discusses that might of contributed to the market's positive reaction to the earnings press release were that app sales increased which doubled Google's "other revenue" from the prior year. Also, Google sold Motorola which was responsible for $2 billion in operating losses since the acquisition of the company, capital expenditures increased by 125 percent which could lead to an increase in future cash flows (this falls in line with what we learned from the last case that revenue is generated by using up assets), the company's overall cash balance increased, and more employees were hired. On the other hand, one factor that might have caused investors to be concerned about Google's recent performance is the fact that there is movement towards smaller phones which resulted in advertisers wanting to pay less for add space. Google overcame this by creating their own advertising style that focused on using photographs and prices that looked like product listings.

Conclusion

First off, I found learning about how investors use non-GAAP measures to better estimate future earnings very interesting. In my free time I often look at possible stocks that I could invest some of my extra money in. I never would have thought to look for or investigate these other measures that could possibly give me a better idea about where a company stands and whether or not they are actually generating revenue from their operations. On the flip side of this, I also found it very interesting that companies can use these same non-GAAP measures and press releases to help keep their stock price up even in periods when earnings are less than analysts' projections. In the case of Google, they were able to justify their earnings not meeting expectations by saying in a press release that there were expenses that were not indicative of their recurring core business operations, such as the stock based compensation, add these amounts back to a non-GAAP measure, make their numbers look more appealing, and then suddenly increase their share price back to even higher than where it was. This really highlights the fact that prior to investing in a company, you really need to dive into a company's financials and any press releases they may have issued to see how they are calculating their earnings numbers.

"On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this thesis study."

Signed ________________________________