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An Analysis on Applications of Contemporary Financial Accounting Topics

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AN ANALYSIS ON APPLICATIONS OF CONTEMPORARY FINANCIAL ACCOUNTING TOPICS

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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Approved by

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Reader: Dean W. Mark Wilder

This thesis is dedicated to my parents, John and Cristina. Thank you for teaching me the value of knowledge and for giving me an abundance of support to learn and grow.

ABSTRACT

AUDREY DAMES: An Analysis on Applications of Contemporary Financial Accounting Topics

(Under the direction of Dr. Victoria Dickinson)

This thesis is composed of twelve independent case studies, each focusing on a different topic in financial accounting. These cases were completed over the course of a year under the instruction of Dr. Dickinson through the Honors Accountancy Independent Study course. To develop this thesis, I examined the information provided in every case study and performed independent research to analyze each unique accounting topic. In addition to independent analysis, the cases were reviewed in collaboration with other students in the Independent Study course, promoting discussion of varying opinions on contemporary accounting theories. The subject matter of the cases ranged from real world scenarios to more abstract accounting principles and trends. While writing this thesis, I integrated knowledge from my intermediate accounting courses and was also challenged to think and research beyond the information taught in the classroom. Many of the case studies provided a deeper insight into more relevant topics in the modern field of accounting than the principles taught in a standard accounting class. Through the process of creating this thesis and my participation in the Independent Study course, I enhanced my critical thinking and problem-solving abilities while also developing skills in professionalism. The knowledge I gained during the composition of this thesis will be beneficial both to my success in graduate school and my future career in public accounting.

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CASE 1

Data Analytics — Domo

Introduction

This case examines the function of data analytics tools in the sphere of accounting. In particular, the platform Domo will be analyzed for its potential contributions as a data gathering and organizing tool for accounting professionals. The software will be investigated for its usefulness in making business processes more efficient and effective within different disciplines of accounting. The value of Domo as an investment in an accounting firm will also be discussed as well as its prospective benefits to a firm.

In working on this case, I learned more about the importance of data analytics and its purpose in the accounting sphere. Domo is one of the many data analytics tools that are available to businesses to assist in streamlining the data collection process and making data analysis more accessible to employees. Learning about data analytics tools now will influence my career as a public accountant because data analytics are becoming increasingly important in the field of accounting. Data analytics is significant to accountants as it allows more comprehensive insight into financial information of companies, so accounting firms can give more reliable and accurate financial analyses to clients. A knowledge of data analytics tools is essential as data analytics rises to the forefront of accounting technology and aids in accounting processes.

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

Domo is a data and analytics tool that can store the data of a business and make business intelligence available to all members of an organization. Domo allows businesses to upload their own data to the platform which allows users to more easily access and use company data. Also, the software cleanses data, so users can more easily focus on the most relevant information for their projects. In addition, Domo allows users to share data and includes other features, such as a chat tool for data discussion, that foster collaboration within the workplace.

Since Domo is a Cloud-based operating system, data is more accessible to all members of an organization who need it, and data can be accessed anywhere, meaning information can be viewed and analyzed off-site. The Cloud-based system provides data updates in real-time which can be especially advantageous in cases of time-sensitive business decisions. Domo also provides users with access to data beyond the boundaries of a single organization, enabling access to both structured and unstructured data, ranging from social media platforms to other financial databases. Furthermore, users of Domo can retrieve problem-solving inspiration from solutions to industry problems that have been developed by other organizations or individuals and are available on Domo.

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

- **Auditing**
- **Tax Planning**

Auditors can benefit from using Domo in their work because the software can help to detect misstatements in various accounts as the organization of large amounts of data allows auditors to recognize mistakes more easily. The feature of real-time data updating would give accountants the opportunity to practice continuous auditing which could not only reduce the overwhelming workload during busier seasons but could also result in a decrease in errors in financial statements. If there were a discrepancy in the inventory account of a client, the auditor could possibly detect the error and adjust it earlier than if he or she only recognized it when preparing the financial statement for the client.

Domo could also assist in internal control to help auditors to provide more reliable and accurate services to clients. Auditors can use Domo in risk assessment for an organization as the software allows users to view trends in the data provided as well as which users logged data in different sections. This provides increased transparency in financial reporting and can help auditors to detect suspicious patterns such as fraud.

In international auditing, the Domo platform is beneficial since it is Cloud-based, so auditing can be performed even if the auditor is not on-site. For example, if a firm based in the United States provides auditing for a company in China, they can access financial data for the company through the Domo software from the home firm rather than have employees frequently travel to China to analyze the data on-site.

Since Domo can organize and cleanse data that a firm provides, tax accountants can more effectively determine future tax predictions. By analyzing the past income data of a client and using real-time data updates to examine current data, tax accountants can assemble more accurate forecasts of future taxes for clients, so clients can prepare for the taxes they will need to pay and make business decisions based on taxes.

In tax planning, accountants can also use data on the taxes of a client to make recommendations on which divisions of the company to expand. The division or divisions that are taxed with the lowest rates could result in a larger profit if an organization chose to expand their efforts in those areas. If tax accountants used Domo to organize income data and past tax history based on the different revenue-earning sectors of a company, they could clearly see which areas incur the most or least taxes.

Domo could also be advantageous in dealing with the taxes of multinational organizations. Since tax laws and rates differ by country, the financial data of the company could be organized based on the income of divisions depending on what country they are based in. Tax accountants could determine how to minimize tax payments in each country the organization has financial interest in, using data such as national tax rates and net income in each of its foreign divisions.

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

To: Katherine Smith

From: Audrey Dames

Subject: Investment in Data Analytics

I am writing to discuss a new data analytics tool that I have become aware of that has the potential to aid the processes in our accounting firm. This software, called Domo, could have the capability to increase the efficiency of our firm if we invest in the product and training our employees in using it.

Domo is a digital platform, designed for businesses, that provides data storage on a Cloud-based system and has the capacity to organize and cleanse data. Although we will initially need to spend time uploading data from the firm to the Cloud, Domo could save time in the long-run as data will be consolidated in one place and will be available to all employees on the platform. By investing in Domo and increasing data analytics usage in the firm, the processes of auditing and tax planning could become more efficient. Data organization permits tax accountants to better view patterns in tax planning for our clients and auditors can conduct internal control with fewer data discrepancies.

In terms of staffing, we would need to train current employees in using the system and introducing all of the features that could benefit daily accounting processes. It may also be advisable to hire another employee to focus specifically on the integration of Domo and data analytics in general. Although training and hiring another member to our firm could be costly, Domo could save the firm costs in future engagements. For example, the firm could reach out to more international clients as data on the Cloud-based system can be accessed from anywhere. This would result in money saved on business trips since employees would not need to travel abroad to gather data.

I believe that the data analytics function of Domo would be an asset to our firm and our clients, and it will help the firm to stay up-to-date with modern accounting technology.

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CASE 2

Financial Statements – Rocky Mountain Chocolate Factory

Introduction

The primary focus of the Rocky Mountain Chocolate Factory case was the preparation of financial statements for a corporation. The transactions that occurred throughout the fiscal year for Rocky Mountain Chocolate Factory were appropriately recorded in a general journal according to the accrual basis of accounting. Then, adjusting entries were made to update the accounts of Rocky Mountain Chocolate Factory before preparing financial statements to follow the accounting principles of revenue recognition and expense recognition. The prepared financial statements consisted of the income statement and balance sheet. Revenue and expense accounts were recorded on the income statement to determine the net income of Rocky Mountain. Once the income statement was prepared, the nominal accounts were closed to retained earnings, and a post-closing trial balance was calculated. Finally, each transaction by Rocky Mountain Chocolate Factory was classified in terms of its nature in cash flows.

Through this case, I utilized past knowledge of data entry in Microsoft Excel, and I furthered my practical knowledge of the program in the context of accounting. I learned about the value of the function tool in the program in expediting the calculations of the financial data required in the trial balances and financial statements. Through practice in Microsoft Excel and composing financial statements now, I can better be prepared for a career in accounting because learning technological skills before I enter my career will increase my efficiency when I start in the workplace as I will not need to learn all of the software for the very first time. By improving my skills in accounting technology and enhancing my knowledge in preparation of financial statements, I will be able to more skillfully perform my duties in an accounting firm when I begin my career.

I. **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 the major assets? Which accounts constitute the major liabilities?**

Based on the description of Rocky Mountain Chocolate Factory, I would expect to see balance sheet accounts such as equipment, buildings, accounts receivable, accounts payable, common stock, retained earnings, and inventory. For major assets, accounts may include inventory, cash, accounts receivable, equipment, and buildings. Major liability accounts could include accounts payable and salaries and wages payable.

II. **Based on the transactions you recorded in the general journal, list at least three adjustments or reclassifications that might need to be made prior to preparing the final financial statements.**

1) There will likely need to be an adjustment for accumulated depreciation and depreciation expenses on property and equipment.
2) An adjustment may have to be made regarding the accrued salaries and wages during the year, either paying the wages or crediting the wages to salaries and wages payable.
3) Rocky Mountain Chocolate Factory may also need to adjust their inventory count after the changes to inventory that occurred in the transactions including the raw materials purchase and wages added to inventory.

Rocky Mountain Chocolate Factory, Inc.

General Journal

For the Year Ended February 28, 2010

		Beginning Balance (2/28/09)	1. Purchase Inventory	2. Incur Factory Wages	3. Sell Inventory for Cash and On Account	4. Pay for Inventory	5. Collect Receivables	6. Incur SG&A (cash and payable)	7. Pay Wages	8. Receive Franchise Fee	9. Purchase PPE	10. Dividends Declared and Paid	11. All Other Transactions	Unadjusted Trial Balance
	Cash and Cash Equivalents	$ 1,253,947.00			$ 17,000,000.00	$ (8,200,000.00)	$ 4,100,000.00	$ (2,000,000.00)	$ (6,423,789.00)	$ 125,000.00	$ (498,832.00)	$ (2,403,458.00)	$ 790,224.00	$ 3,743,092.00
	Accounts Receivable	$ 4,229,733.00			$ 5,000,000.00		$ (4,100,000.00)						$ (702,207.00)	$ 4,427,526.00
	Notes Receivable, Current	$ -											$ 91,059.00	$ 91,059.00
	Inventories	$ 4,064,611.00	$ 7,500,000.00	$ 6,000,000.00	$ (14,000,000.00)								$ (66,328.00)	$ 3,498,283.00
	Deferred Income Taxes	$ 369,197.00											$ 92,052.00	$ 461,249.00
	Other	$ 224,378.00											$ (4,215.00)	$ 220,163.00
	Property and Equipment, Net	$ 5,253,598.00									$ 498,832.00		$ 132,859.00	$ 5,885,289.00
	Notes Receivable, less current portion	$ 124,452.00											$ 139,198.00	$ 263,650.00
	Goodwill, net	$ 1,046,944.00											$ -	$ 1,046,944.00
	Intangible Assets, net	$ 183,135.00											$ (73,110.00)	$ 110,025.00
Dr.	Other	$ 91,057.00											$ (3,007.00)	$ 88,050.00
	Accounts Payable	$ 1,074,643.00	$ 7,500,000.00			$ (8,200,000.00)							$ 503,189.00	$ 877,832.00
	Accrued Salaries and Wages	$ 423,789.00		$ 6,000,000.00					$ (6,423,789.00)				$ -	$ -
	Other Accrued Expenses	$ 531,941.00						$ 3,300,000.00					$ (2,885,413.00)	$ 946,528.00
	Dividend payable	$ 598,986.00										$ 3,709.00	$ (1.00)	$ 602,694.00
	Deferred Income	$ 142,000.00								$ 125,000.00			$ (46,062.00)	$ 220,938.00
	Deferred Income Taxes	$ 827,700.00											$ 66,729.00	$ 894,429.00
	Common Stock	$ 179,696.00											$ 1,112.00	$ 180,808.00
	Additional Paid-In Capital	$ 7,311,280.00											$ 315,322.00	$ 7,626,602.00
	Retained Earnings	$ 5,751,017.00										$ (2,407,167.00)		$ 3,343,850.00
	Sales	$ -			$ 22,000,000.00								$ 944,017.00	$ 22,944,017.00
Cr.	Franchise and Royalty Fees	$ -											$ 5,492,531.00	$ 5,492,531.00
	Cost of Sales	$ -			$ 14,000,000.00								$ 693,786.00	$ 14,693,786.00
	Franchise Costs	$ -											$ 1,499,477.00	$ 1,499,477.00
	Sales & Marketing	$ -						$ 1,505,431.00						$ 1,505,431.00
	General & Administrative	$ -						$ 2,044,569.00					$ (261,622.00)	$ 1,782,947.00
	Retail Operating	$ -						$ 1,750,000.00						$ 1,750,000.00
	Depreciation & Amortization	$ -												$ -
	Interest Income	$ -											$ (27,210.00)	$ (27,210.00)
Dr.	Income Tax Expense	$ -											$ 2,090,468.00	$ 2,090,468.00

FIGURE 2-1a: Rocky Mountain Chocolate Factory, Inc. General Journal, Part 1

Rocky Mountain Chocolate Factory, Inc.

General Journal

For the Year Ended February 28, 2010

		Unadjusted Trial Balance	12. Adjust for Inventory Count	13. Record Depreciation	14. Wage Accrual	15. Consultant's Report (no entry)	Pre-Closing Trial Balance	16. Closing Entry	Post-Closing (Ending Balance)	Actual February 28, 2010 F/S figures
	Cash and Cash Equivalents	$ 3,743,092.00					$ 3,743,092.00		$ 3,743,092.00	$ 3,743,092.00
	Accounts Receivable	$ 4,427,526.00					$ 4,427,526.00		$ 4,427,526.00	$ 4,427,526.00
	Notes Receivable, Current	$ 91,059.00					$ 91,059.00		$ 91,059.00	$ 91,059.00
	Inventories	$ 3,498,283.00	$ (216,836.00)				$ 3,281,447.00		$ 3,281,447.00	$ 3,281,447.00
	Deferred Income Taxes	$ 461,249.00					$ 461,249.00		$ 461,249.00	$ 461,249.00
	Other	$ 220,163.00					$ 220,163.00		$ 220,163.00	$ 220,163.00
	Property and Equipment, Net	$ 5,885,289.00		$ (698,580.00)			$ 5,186,709.00		$ 5,186,709.00	$ 5,186,709.00
	Notes Receivable, less current portion	$ 263,650.00					$ 263,650.00		$ 263,650.00	$ 263,650.00
	Goodwill, net	$ 1,046,944.00					$ 1,046,944.00		$ 1,046,944.00	$ 1,046,944.00
	Intangible Assets, net	$ 110,025.00					$ 110,025.00		$ 110,025.00	$ 110,025.00
Dr.	Other	$ 88,050.00					$ 88,050.00		$ 88,050.00	$ 88,050.00
	Accounts Payable	$ 877,832.00					$ 877,832.00		$ 877,832.00	$ 877,832.00
	Accrued Salaries and Wages	$ -			$ 646,156.00		$ 646,156.00		$ 646,156.00	$ 646,156.00
	Other Accrued Expenses	$ 946,528.00					$ 946,528.00		$ 946,528.00	$ 946,528.00
	Dividend payable	$ 602,694.00					$ 602,694.00		$ 602,694.00	$ 602,694.00
	Deferred Income	$ 220,938.00					$ 220,938.00		$ 220,938.00	$ 220,938.00
	Deferred Income Taxes	$ 894,429.00					$ 894,429.00		$ 894,429.00	$ 894,429.00
	Common Stock	$ 180,808.00					$ 180,808.00		$ 180,808.00	$ 180,808.00
	Additional Paid-In Capital	$ 7,626,602.00					$ 7,626,602.00		$ 7,626,602.00	$ 7,626,602.00
	Retained Earnings	$ 3,343,850.00					$ 3,343,850.00	$ 3,580,077.00	$ 6,923,927.00	$ 6,923,927.00
	Sales	$ 22,944,017.00					$ 22,944,017.00	$ (22,944,017.00)	$ -	$ 22,944,017.00
Cr.	Franchise and Royalty Fees	$ 5,492,531.00					$ 5,492,531.00	$ (5,492,531.00)	$ -	$ 5,492,531.00
	Cost of Sales	$ 14,693,786.00	$ 216,836.00				$ 14,910,622.00	$ (14,910,622.00)	$ -	$ 14,910,622.00
	Franchise Costs	$ 1,499,477.00					$ 1,499,477.00	$ (1,499,477.00)	$ -	$ 1,499,477.00
	Sales & Marketing	$ 1,505,431.00					$ 1,505,431.00	$ (1,505,431.00)	$ -	$ 1,505,431.00
	General & Administrative	$ 1,782,947.00			$ 639,200.00		$ 2,422,147.00	$ (2,422,147.00)	$ -	$ 2,422,147.00
	Retail Operating	$ 1,750,000.00			$ 6,956.00		$ 1,756,956.00	$ (1,756,956.00)	$ -	$ 1,756,956.00
	Depreciation & Amortization	$ -		$ 698,580.00			$ 698,580.00	$ (698,580.00)	$ -	$ 698,580.00
	Interest Income	$ (27,210.00)					$ (27,210.00)	$ 27,210.00	$ -	$ (27,210.00)
Dr.	Income Tax Expense	$ 2,090,468.00					$ 2,090,468.00	$ (2,090,468.00)	$ -	$ 2,090,468.00

FIGURE 2-1b: Rocky Mountain Chocolate Factory, Inc. General Journal, Part 2

Rocky Mountain Chocolate Factory, Inc.		
Income Statement		
For the Year Ended February 28, 2010		
Revenues		
Sales		$ 22,944,017.00
Franchise and Royalty Fees		$ 5,492,531.00
Total Revenues		$ 28,436,548.00
Costs and Expenses		
Cost of Sales		$ 14,910,622.00
Franchise Costs		$ 1,499,477.00
Sales & Marketing		$ 1,505,431.00
General & Administrative		$ 2,422,147.00
Retail Operating		$ 1,756,956.00
Depreciation & Amortization		$ 698,580.00
Total Costs and Expenses		$ 22,793,213.00
Operating Income		$ 5,643,335.00
Interest Income		$ 27,210.00
Income Before Income Taxes		$ 5,670,545.00
Income Tax Expense		$ 2,090,468.00
Net Income		$ 3,580,077.00
Basic Earnings per Common Share		$ 0.60
=Net Income/Weighted Average Common Shares Outstanding (6,012,717)		

FIGURE 2-2: Rocky Mountain Chocolate Factory, Inc. Income Statement

Rocky Mountain Chocolate Factory, Inc.		
Balance Sheet		
As of February 28, 2010		
Assets		
Current Assets		
Cash and Cash Equivalents	$	3,743,092.00
Accounts Receivable	$	4,427,526.00
Notes Receivable, Current	$	91,059.00
Inventories	$	3,281,447.00
Deferred Income Taxes	$	461,249.00
Other	$	220,163.00
Total Current Assets	$	12,224,536.00
Property and Equipment, Net	$	5,186,709.00
Other Assets		
Notes Receivable, less current portion	$	263,650.00
Goodwill, net	$	1,046,944.00
Intangible Assets, net	$	110,025.00
Other	$	88,050.00
Total Other Assets	$	1,508,669.00
Total Assets	$	18,919,914.00
Liabilities and Stockholders' Equity		
Current Liabilities		
Accounts Payable	$	877,832.00
Accrued Salaries and Wages	$	646,156.00
Other Accrued Expenses	$	946,528.00
Dividend payable	$	602,694.00
Deferred Income	$	220,938.00
Total Current Liabilities	$	3,294,148.00
Deferred Income	$	894,429.00
Stockholders' Equity		
Common Stock	$	180,808.00
Additional Paid-In Capital	$	7,626,602.00
Retained Earnings	$	6,923,927.00
Total Stockholders' Equity	$	14,731,337.00
Total Liabilities and Stockholders' Equity	$	18,919,914.00

FIGURE 2-3: Rocky Mountain Chocolate Factory, Inc. Balance Sheet

	Rocky Mountain Chocolate Factory, Inc.	
	For each transaction, indicate whether the transaction would appear in the "operating," "investing," or "financing" section of the statement of cash flows.	
	Transaction	Section in Statement of Cash Flows
1)	Purchase Inventory	Operating
2)	Incur Factory Wages	Operating
3)	Sell Inventory for Cash and On Account	Operating
4)	Pay for Inventory	Operating
5)	Collect Receivables	Operating
6)	Incur SG&A (cash and payable)	Operating
7)	Pay Wages	Operating
8)	Receive Franchise Fee	Operating
9)	Purchase PPE	Investing
10)	Dividends Declared and Paid	Financing

FIGURE 2-4: Rocky Mountain Chocolate Factory, Inc. Cash Flow Analysis

CASE 3

Decisions in the Accounting Career Path

Introduction

The purpose of this case was to consider the decisions that can be made by students pursuing a major in accounting regarding their future career path. The discussion consisted of several scenarios that recreated real conversations held by accounting students about how an accounting major can impact their futures and potentially difficult choices to make in a career in accounting. With each scenario presented, the goal of the discussion was to consider a personal standpoint with reasoning on the issue that was presented, to help guide future career decisions and contemplate the consequences that could result from choosing one option over another. Since accounting students are asked early on in their college experience questions such whether they want to pursue tax or audit and where they want to locate to, it is important to consider some of these decisions on a regular basis.

This case was especially relevant to the decisions I will need to consider as I pursue a degree in accounting and start my career in the accounting field. I learned the importance of commitment to an accounting firm, for at least a few years, since the firms dedicate a significant amount of resources and time in recruiting students to work for them. In addition, I realized the notable value of a degree in accounting. Since accounting is considered the "language of business," it is portable and can provide gateways to other careers. This portability provides more flexibility in choosing a new career path after committing the time and work to an accounting firm that the firm had put into recruitment. Although pursuing a career in accounting can be a significant commitment and can sometimes present difficult choices, there are many benefits that accompany a degree in accounting and experience in the accounting field.

Scenario One

In the first scenario, an Ole Miss accounting student aims to go to law school to study tax law after his time as an undergraduate student since his cousin works in tax law in New York City and has a large salary. The student plans to complete the Bachelor of Accountancy program and undertake a spring accounting internship because he believes that the experience from the internship will enhance his resume for law school applications. His classmate reminds him that law school is a significant financial and time commitment compared to the Master of Accountancy program, which only takes one year to complete. However, the student insists that a law degree will provide him with a higher salary than if he only earned his master's in accounting.

I agree with the accounting student that wants to go to law school after finishing the accounting program because I believe that if he really interested in tax law, a degree in accounting can help him excel in his law studies. Although the Master in Accountancy program is less of a commitment and will have a lower tuition cost than going to law school, a career in law will most likely pay a better entry salary, allowing law school to be a more feasible option for the student since he will be able to pay off his student loans. If he works in an accounting firm with his law degree, he will initially be paid more though only in the first few years, but with a law degree, a law firm will most likely pay a great deal more than an accounting firm. Both the law and accounting fields require intensive work from their employees, but law can be more time-consuming than accounting since its busy season is year-round in comparison to the business of tax season in accounting. However, both fields are experiencing an exodus of employees, opening jobs for graduating students. With a law degree, the student has the option and flexibility to eventually open his own practice. Even if the student also decides that he is interested in accounting, there are combined accounting master's degrees and juris doctor degree programs available, so he can study both.

Though many may argue that accepting an accounting internship in the spring may take away spots from other students and failure to accept an offer after the internship reflects poorly on the School of Accountancy since the recruiting process is expensive, it is important for each student to discover the most fitting career and make the best decisions for one's own future. The internship can be beneficial to any student as it allows students to realize if a career in accounting is a good fit for them.

Scenario Two

The second scenario features two students in the accounting program at the University of Mississippi discussing their futures after finishing the accounting program. Though neither student enjoys their studies in accounting, both students are in the accounting program to achieve a better future for themselves, planning to choose different careers once they have earned their accounting degrees. The students agree that the high ranking of the Patterson School of Accountancy is beneficial to their education and appealing to employers, but one of the students intends to go into investment banking and the other would prefer a career in consulting as these careers provide higher salaries. Also, the students enjoy some of the benefits of accounting because it permits traveling and the spring internship provides valuable experience for a noteworthy MBA program.

I believe that the students have a valid argument in pursuing a degree in accounting to set themselves up for success in different career paths. Although there are more job openings in the accounting field than in the areas the students wanted jobs in, some careers have no direct path in a college setting, and a degree in accounting can be an asset in reaching a place in those careers. It is difficult to access careers in investment banking and consulting because strong connections are important in these fields, but experience in accounting can help students to develop the business relationships they need to access these career paths. It is important to focus on the best opportunities for your own future because the business world heavily revolves around that idea.

Although I agree with the students on the topic of changing career paths after college, I believe that commitment to accounting firms is still important. If the students are planning to take on the spring accounting internship, I think they should commit to the accounting firm for a few years before they decide to transition to another career. Accounting recruitment requires a lot of time and money from the firms and the offices, so much that the “payback period” for the firm to recover its investments in students is approximately three years. Three years is a short time period to work for the firm that invested in a student so carefully, and the experience a student could gain from those three years could benefit them even more in applying for MBA programs and new jobs. The initial working period after college is also the time for exploration, so students can discover if accounting is the right fit for them or if they prefer a different area of business. In addition, accounting firms can help you get where you want to be based on what you are interested in since they would prefer dedicated workers, as long as the workers have given their commitment to the firm. Since accounting is a versatile degree, students can benefit from it in many different careers.

Scenario Three

In the first part the last scenario, a student has completed his spring internship at a Big Four accounting firm in Washington, D.C. and is nearly finished with the Master in Accountancy program. He emails his professor to ask about the process of transferring his offer with the accounting firm to the Big Four office in Dallas because it is his hometown, and he wants to move back.

I think that the student should have the option to transfer locations in the accounting firm. Although commitment and loyalty to an office can play a large role in how an employee is perceived by his company, choosing and staying in a location is a big commitment for a recent college graduate. The decision to work in a location outside of his hometown provided good experience to work outside of his comfort zone and encounter a different culture, but if he did not like the work culture in the Washington, D.C. office, it could impact his work. If he feels extremely homesick and does not feel comfortable in the workplace, his mood may negatively affect his productivity and quality of work as he may not be able to focus on his tasks.

Later, the student's professor responds that the Dallas office of the Big Four is a difficult location to earn an offer because it is a popular location. She tells the student that he should be able to sufficiently explain why he wants to move because the Washington, D.C. office used a lot of resources in recruiting. It may take a period of time to transfer to the Dallas office, but if the student is a high performer in the Washington, D.C. office, he can prove himself worthy of transferring to another office. The student responds to the professor that he wanted to start a new life in Washington, D.C. but he believes that Dallas is a better fit for him and realizes that he should have started in the Dallas office.

It is important for students to commit to their accounting firms since the firms dedicate so much time and many resources into recruiting students. However, students should also have the option to be where they want to be, so they can focus more on performing their work at their best capacity. Sometimes the circumstances surrounding the desire to transfer are also crucial to note in deciding his request to transfer as family or health issues can result in a transfer that is necessary. Furthermore, it is important for this student to be transparent with his superiors and express that he wants to change locations and why because it will help him build better relationships with his colleagues and achieve what he wants to do. Although the Washington, D.C. office provided resources to recruit and train the student, he still wants to commit to the firm, and that communicates his dedication to the firm.

CASE 4

Impairment of Debt Securities

Introduction

This case presented the situation of the fictionalized Generic Bank, whose CFO, Joshua Winters, is determining what action he should take to increase the liquidity of the bank for company expansion and other goals set by the bank in the year 20x2. Though the company is well capitalized and has access to bank regulatory resources such as Federal Home Loan Bank (FHLB) advances and Fed Funds, Winters is contemplating whether or not to sell some of the available-for-sale (AFS) securities owned by the bank to contribute to liquidity. The components of the case required responses judging the assessment of impairment on AFS securities in the event of a sale of securities based on FASB Accounting Standards Codification (ASC). It also called for the status of impairment to be examined from external sources, including that of an external auditor for Generic Bank, Heather Herring.

Working on this case, I learned more about debt securities than I had learned in my accounting classes and became aware of the consequences of impairment. Through my research on AFS debt securities and the application of impairment losses, I discovered more about the implementation of the FASB ASC in a practical accounting situation. Although I have learned about the ASC in other accounting courses, this case taught me how to analyze the GAAP described in the ASC and apply it in accounting situations. In addition, I realized the importance of viewing financial transactions and events from different financial parties involved as I analyzed the securities sale from the viewpoint of the CFO, the external auditor, and a bank regulator. By considering these different viewpoints, I gained a more nuanced understanding of impairment losses and application of FASB ASC according to different financial bodies.

I. **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?**

Generic Bank does have an impairment loss on five of the seven designated securities sold in early 20x3. ASC 326-30 requires AFS securities to be assessed on an individual level instead of aggregating the securities sold, so only individual securities that fit the guidelines for impairment will be deemed to have impairment losses. The securities with the CUSIP numbers ending, 067 and 096, are not affected by impairment because the fair values for these securities were greater than their amortized costs, resulting in gain upon sale. For the remaining five securities sold, with CUSIP numbers ending: 003, 015, 025, 030, and 076, Generic Bank does have an impairment loss since the fair values of these securities are less than the amortized costs. According to ASC 326-30, the bank should recognize the impairment on the AFS securities when the fair value of the securities is lower than the amortized cost and the bank has the intention to sell securities before the amortized cost is recovered. Generic Bank has deemed the loss on these securities to be the result of interest rates rather than credit deterioration and does not have the intent to hold these securities until the declines in fair value recover or until maturity because the bank is planning to sell the securities to increase liquidity. The amount of the impairment loss on each security is determined by the difference between the amortized cost and fair value of the security.

II. **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?**

Generic Bank does not have an impairment on any of its securities other than the designated five out of seven securities sold in 20x3. Since Generic Bank has designated all of its investments in debt securities as available-for-sale, the securities are not subject to lifetime credit loss in the current expected credit loss (CECL) impairment model in ASU 2016-13. In addition, according to ASC 326-30-35-4 and -5, only debt securities under the same CUSIP identification number may be combined to measure unrealized gains and losses on securities, and entities cannot mix separate securities in evaluating impairment. Since none of the other securities of Generic Bank share the same CUSIP identification as those sold in 20x3, the other securities are not affected by the impairment loss on the sold securities. ASC 326-30 also does not require the amount of time that a fair value has been lower than amortized cost to be considered in determining if an impairment exists, so a remaining security that has had a fair value less than the amortized cost for over a year may not be recognized in a position of impairment. Furthermore, the bank's intent and ability to hold its other securities to recovery of the fair value should not be majorly impacted since Generic Bank is well capitalized and has access to FHLB advances and Fed Funds if they need to further increase liquidity after the sale of the securities. Therefore, Generic Bank will most likely not be required to sell other securities before they reach amortized cost, and their other securities will not be considered impaired.

III. 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?

In the role of an external auditor such as Heather Herring, the impairment position of the debt securities and the intent and ability of Generic Bank to hold the securities until maturity or recovery of their fair value may be scrutinized more. Herring might perform a cash flow analysis to determine if the future expected cash flows expected to be provided by the AFS securities will allow Generic Bank to hold the securities until recovery or maturity. As an external auditor, Herring may also further test the securities to see if the loss positions are actually the result of interest rate changes or if credit deterioration may have affected the fair value of the securities.

Similar to an external auditor, a bank regulator will also apply more scrutiny in determining whether the securities owned by Generic Bank may be impaired. According to the Office of the Comptroller of the Currency (OCC), bank management is responsible for ensuring that its reports follow GAAP. The OCC further states that bank regulators must review the policies of banks to verify that the banks are using updated accounting principles in their practices and that their documentation of financial events reflects the standards. The duties of the bank regulator in determining impairment in other securities, as described by the FRB may include investigating whether the bank must dispose of significant assets or determine whether the market condition in the region where Generic Bank operates could actually provide the prospect of recovery of fair value.

For both the external auditor and bank regulator, the sales of securities in early 20x3 may be analyzed to determine if the Generic Bank other securities have impairment losses if these authorities find that other securities fit the definition of impairment in ASC 326-30 based on an investigation into the state of the securities. However, these parties could also discover that none of the securities are impaired if they judge that the bank does have the intent and ability to hold the other securities despite the securities sale.

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

If the securities sold had been collectively in a net gain position, an impairment loss would still only be applied to the individual securities sold that had lower fair values than amortized costs since impairment is determined on an individual security level. Although the securities may have been sold in a net gain position as an aggregated group, ASC 326-30 states that securities should be judged on an individual level for impairment losses, so only the securities sold that meet the definition of impairment as described earlier will be deemed impaired.

If all the securities sold were in gain positions, none of the securities sold would have impairment losses. Since an impairment loss is first defined by the fair value of the AFS security being lower than the amortized cost of the security, a gain position on a security would defy this description since the amortized cost would be greater than the fair value of the security. An unrealized holding gain would be recognized upon sale of these securities.

V. 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?

If Generic Bank is adequately capitalized instead of well capitalized and decides to sell the securities in early 20x3, they may have to reassess the impairment status of other debt securities in their portfolio and the bank's intent and ability to hold those securities until maturity or recovery. If the firm is only adequately capitalized rather than well capitalized, the bank's ability and intent to hold the securities may be affected. Some of the securities owned by Generic Bank other than the securities sold may be designated as more likely than not to be required to sell at a loss, moving those securities to an impairment loss position. The likeliness of needing to sell the securities at a loss is affected by factors such as working capital requirements and regulatory obligations set by bank regulators in addition to the probability that these factors will occur during the expected recovery period. The assessment of Generic Bank's intent and ability to hold its securities to maturity or recovery of fair value is significant since the firm may need to sell other securities to improve its capital ratios and fulfill borrowing obligations as they do not have as much access to FHLB advances and Fed Funds as they would have if they were well capitalized. This means that Generic Bank would be more dependent on the sales of securities for increasing its liquidity. The firm may not have an impairment loss on securities other than the seven sold if Generic Bank can show its intent and ability to hold the other securities it invests in, but there are many important factors in considering the bank's intent-and-ability-to-hold designation.

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CASE 5

City Selection – Los Angeles and Chicago

Introduction

In this case, the focus was placed on the question facing many prospective accounting recruits of where to locate to and live for at least the first three to five years of one's career. Since many accounting firms recruit students based on their preferred location choices, it is an important decision to make for upper-level accounting students that requires a great amount of thought and research. After choosing my personal top two location preferences of Los Angeles and Chicago, I conducted research on basic information about each city, the general cultures of the cities, various factors that contribute to calculations of the potential cost of living, and other practical elements of life within the cities to give an overview of how life would be if I were to choose to pursue a career in accounting in either Los Angeles or Chicago.

In researching both Los Angeles and Chicago, I discovered a lot of specific details about typical life in each city, such as the popular grocery stores among locals and traditional modes of transportation. I was also able to explore opportunities in both cities for involvement in local organizations and regular recreation and entertainment. This case allowed me to deeply consider my future in each city in practical terms, including the expenses of living and fitting into the city cultures, and I was better able to envision myself living in each city. Although I was familiar with Los Angeles before conducting research, having visited family in the city many times, my research provided a new perspective of the city through the eyes of a young, independent professional as I needed to consider the finances required to live in the city and how my social life could unfold. Having only visited Chicago for a few brief vacations, I felt that the case provided a more in-depth understanding of the city and its culture outside of the tourist perspective.

Los Angeles

I. What is the population?

There are approximately 10.1 million people living in the greater metro area.

II. Describe the climate and seasonal fluctuations.

There are several geographical factors that affect the climate of Los Angeles. The proximity of the city to the ocean can result in cooler weather closer to the coast; however, its position near deserts and valleys exposes the inland city to moderately warm to hot weather, with downtown Los Angeles experiencing temperatures surpassing 80°F in the hottest month of August. The city also experiences smog, the smoky fog that is a result of air pollution. The seasonal fluctuations of Los Angeles weather are limited as part of the year is a warm, dry season from April to November while the other part is cooler and slightly wet, without radical weather changes between seasons.

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

Los Angeles extends to the Pacific Ocean, so one of its most noteworthy geographic features is its range of beaches, from Redondo Beach to Venice Beach. Another significant geological feature of Los Angeles is its mountain ranges, including the San Gabriel Mountains and Santa Monica Mountains. The Santa Monica Mountains are home to the Hollywood Hills, which feature the famous Hollywood Sign, and also contain Griffith Park, a popular hiking destination among locals and tourists alike.

IV. What are the individual tax rates within the city (Consider federal, state and local income tax, property tax, and other taxes. Quantify what this means based on a starting salary of approximately $50,000/year)?

For an annual salary of $50,000, the marginal federal income tax rate for a single filer is 22 percent and FICA is 7.65 percent. As a result, the effective federal tax rate is 11.28 percent for this tax bracket, and $5,639 of a $50,000 salary would be taken for the federal income tax, and $3,825 would be owed for FICA. The marginal state income tax rate in California for this salary is 8 percent with an effective tax rate of 3.55 percent. This would result in $1,777 owed for California state income tax. Meanwhile, there is no local income state tax in Los Angeles county. The California state sales tax is 7.25 percent, and the local sales tax for the city of Los Angeles is 2.25 percent, so the total sales tax for purchases in Los Angeles is 9.5 percent.

V. What transportation hubs are in the city?

The main transportation hub in the city is Los Angeles International Airport (LAX), one of the largest airports in the world, which has eight terminals for domestic flights and the Tom Bradley International Terminal. Los Angeles Union Station is a hub for trainlines like Amtrak, and it also is a stop for the Los Angeles Metro Rail, the main source of public transportation in the city. The Metro Rail consists of six lines that run throughout Los Angeles in addition to over 200 bus lines.

VI. What is the city's most prevalent industries?

Los Angeles may be best known for its entertainment industry since the city is considered to be the "Entertainment Capital of the World." The entertainment industry also bolsters the city's successful tourism industry. However, Los Angeles also has a significant manufacturing industry, particularly in apparel and electronics, and major industries in aerospace defense and finance.

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

According a U.S. News Ranking, California is considered the state with the eleventh best health care out of the fifty states, with a ranking of 14 among the 50 states for health care quality and the top ranking in the country for public health. With UCLA Medical Center, one of the world's most prestigious hospitals, located in the city among other exceptional hospitals and clinics, Los Angeles has excellent health care options available.

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

In Los Angeles, common types of crime include homicide, assault, robbery, and theft, particularly motor vehicle theft, based on statistics from the Los Angeles Police Department. The particular neighborhoods that would be safe to avoid in Los Angeles include Compton, East Los Angeles, and Watts, and even downtown Los Angeles at night can be notably dangerous.

IX. Based on where you see yourself living for the first three years, how much rent do you expect to pay?

In a more affordable suburban neighborhood in Los Angeles, such as West Los Angeles or Culver City, the average cost for monthly rent on a small studio or one-bedroom apartment can range between $1500 and $2000. One apartment located near Culver City that I reviewed was a studio apartment with one bathroom that is newly renovated and has a rent of $1,545 per month. Both the kitchen and the bathroom have new appliances and fixtures, and the flooring of the entire space was recently redone.

FIGURE 5-1: (Zillow)

FIGURE 5-2: (Zillow)

The second apartment I looked into was a 950-square-feet, one bedroom and one-bathroom apartment in the neighborhood of Palms that had a monthly rent of $1,500. The apartment complex that contains this unit features a gated entry, an attached garage for parking in addition to street parking and is located within a safe area. However, the appliances in the apartment seemed to be slightly outdated, and the living space is small. Since the cost of living is extremely high in Los Angeles, especially in comparison with the rest of the United States, it is difficult to find affordable places to live or have a lot of space, so I will have to settle on finding a space that may not be large but has a less expensive rent. Although it is possible to afford the high rent expenses in Los Angeles with the help of a well-structured monthly budget, another factor to consider in choosing a living situation is the presence of family member in Los Angeles. Because cost of living is so high in the city, especially for a new professional, several of my family members have offered to let me stay in their houses while I am adjusting to my career and living in Los Angeles. Accepting one of their offers would be cost-effective because I could simultaneously save money to rent or even buy a place of my own.

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

Among Los Angeles locals, the most popular mode of commuting is driving a car in the notorious traffic of the Los Angeles freeways. From the West Los Angeles area to the financial district in downtown Los Angeles, where many accounting firms are located, the commute could last anywhere between twenty minutes and one hour, depending on the heaviness of the traffic.

XI. Where will you do your grocery shopping?

Some of the most frequented grocery stores in Los Angeles by locals are Ralphs and Pavilions, Southern California grocery stores. In addition, Trader Joe's and Target are

XII. How will you do your laundry?

Both of the properties described previously feature shared laundry facilities in the apartment complexes where I would be able to do laundry within a close radius of my own living space. In addition, I could also do laundry at the houses of family members.

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

Since I have been raised in a Catholic family and continue to go to a Catholic church, I would like to join a church in Los Angeles. There are many Catholic churches in the areas that I would be interested in living in, including St. Timothy's Catholic Church or the University Catholic Center at UCLA, where I could connect with people who share my religious beliefs that are my age. With the many beaches on the Pacific Coast, I would hope to get involved in an environmental organization that helps to clean the beaches and reduce marine pollution, such as Heal the Bay. I would also be interested in volunteering for one of the many free museums in the city, possibly as a docent for an art gallery, such as the Getty Villa or Getty Center.

XIV. What are the sports, entertainment, or recreational activities that you would be most likely to engage in within the city?

Los Angeles is a location of endless entertainment and recreational activities. Since the city is within proximity of the multitude of beaches in Southern California, I would like to learn how to surf and to possibly participate in other marine activities, like sailing. I would also be interested in becoming a more avid hiker, with the availability of many popular hiking destinations, including Griffith Park and Mount Baldy. To take advantage of the distinguished entertainment industry of Los Angeles, I hope to attend events at comedy clubs like Laugh Factory or Upright Citizens Brigade Theatre. Also, visiting at least some of the many museums scattered throughout the city would be fascinating, whether it be the Getty Villa or the Los Angeles County Museum of Art. In addition, the drive to Disneyland is less than an hour from the city, so I would be interested in getting season passes to visit the theme park often.

XV. 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?

The trip from Los Angeles to my hometown of St. Louis is the fastest journey and often most practical on a plane. The trip from LAX to St. Louis Lambert International consists of a four-hour nonstop plane ride, and a round-trip ticket can cost between $300 to $400 during the typical travel months during summer and in December. An alternative mode of returning to St. Louis would be a 28-hour road trip, that can be practically broken down into two or three days. Although the trip requires more time commitment than a flight, driving can sometimes be more affordable than a flight if more than one person is travelling. A one-way trip from Los Angeles to St. Louis can be expected to cost about $217.73 based on an estimate of 71 gallons of gas required for the drive at an average rate of about $2.983 per gallon, according to AAA.

XVI. 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.

FIGURE 5-3: Estimated Monthly Budget – Los Angeles

Monthly Salary ($60,000÷12)	$5,000.00
Income Taxes (for $60,000 salary, total annual income taxes = $13,650)	$1,137.50
Net Income	**$3,862.50**
Rent + Utilities	$1,700
Groceries	$200
Transportation Expenses	$350
Health Insurance	$300
Subscription Payments	$100
Recreation and Entertainment	$200
Personal Expenses	$200
Income left for savings and other	$812.50

Chicago

I. What is the population?

Chicago is home to more than 2.72 million people.

II. Describe the climate and seasonal fluctuations.

There is no steady climate in Chicago as weather of the city varies throughout the course of the year. Although Chicago experiences all four seasons, the seasonal fluctuations in the city can feature extreme points on the scale of weather, with an average summer heat in July of about 75°F, impacted by humidity, and a January average temperature of 28°F with snow. The presence of Lake Michigan allows lakeside areas to experience some moderate coolness in the summer and provides slight warmth in the winter. The wind from the lake is also thought to be the reason for Chicago's nickname, the "Windy City."

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

The city of Chicago was built on the Chicago Plain, so the topography of the city is mostly flat, but this flatness provides for a noteworthy cityscape of skyscrapers. However, Chicago also features significant bodies of water as the city is situated on the coast of Lake Michigan and its beaches, and the Chicago River flows from Lake Michigan, running throughout the city.

IV. What are the individual tax rates within the city (Consider federal, state and local income tax, property tax, and other taxes. Quantify what this means based on a starting salary of approximately $50,000/year)?

Since the marginal federal income tax rate is 22 percent with an 11.28 percent effective tax rate, the federal income tax I would pay on a salary of about $50,000 would be $5,639, and for FICA, I would pay $3,825 at the 7.65 percent rate. The marginal Illinois state income tax rate is 4.95 percent, so the state income taxes on a $50,000 salary would be $2,367 at the effective rate of 4.73 percent, and Chicago does not have local income taxes. The total sales tax on for purchases in Chicago is 10.25 percent, with Illinois state sales tax rate at 6.25 percent and the local sales tax of Chicago at 4 percent.

V. What transportation hubs are in the city?

Chicago is home to two major airports for both domestic and international air travel, O'Hare International Airport and Chicago Midway Airport. In addition, Chicago Union Station is the main transportation hub for trains, and Amtrak runs the most connections through this station. Chicago Transit Authority is the main source of public transportation in Chicago with available bus services and train lines, including the "El" train.

VI. What is the city's most prevalent industries?

Chicago is best known for its major industries in manufacturing, publishing and printing of nationally distributed magazines and academic material, finance, and food-processing as one of the country's biggest candy producers.

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

A U.S. News Report ranking of the best states for health care rated Illinois at the position of 27 among the fifty states with its quality of health care ranked at 37. However, Chicago may experience better healthcare in comparison with the rest of the state because the healthcare industry is growing, with a current value of nearly $70 billion and an increasing number of medical research centers from the 140 centers currently existing.

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

According to the Chicago Police Department, common crime complaints in the city include murder, sexual assault, robbery, battery, and various types of theft. Chicago is known for being a dangerous city, and although there are many locations in Chicago that are important to avoid for safety reasons, the three areas with the highest murder rates were West Garfield Park, North Lawndale, and Englewood. Fuller Park, Burnside, Riverdale join the ranks of dangerous neighborhoods since these areas have some of the highest assault and attack rates.

IX. Based on where you see yourself living for the first three years, how much rent do you expect to pay?

In Chicago, safety and lower rent expenses are major factors to consider in finding a place to live, so some of the best neighborhoods recommended for young professionals to find accommodations include Lake View, where Wrigley Field, home of the Cubs, is located and Lincoln Park, where monthly rent averages between $1,000 and $1,300. In Lake View, I discovered a studio apartment with one bathroom that has a monthly rent of $930. This unit is located within a building that also houses a fitness room and a laundry room, and it is close to public transportation stops. Another studio apartment I found, located in Lincoln Park, has a rent of $1,235 per month, and is measured at 208 square feet. This apartment is located in a building that not only contains a fitness center and laundry room but also houses several restaurants and has a great view of the cityscape.

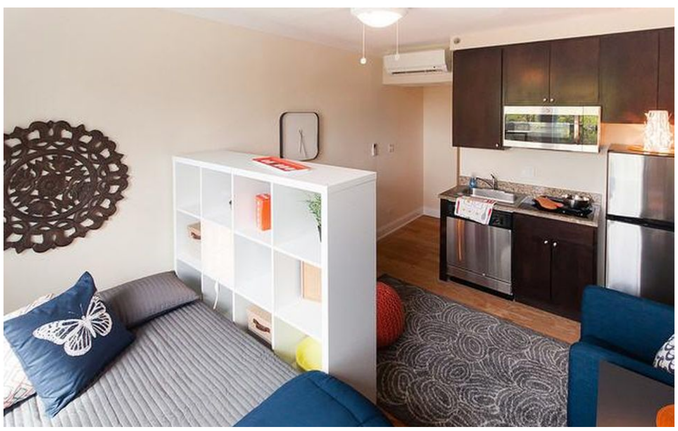

FIGURE 5-4: (Zillow)

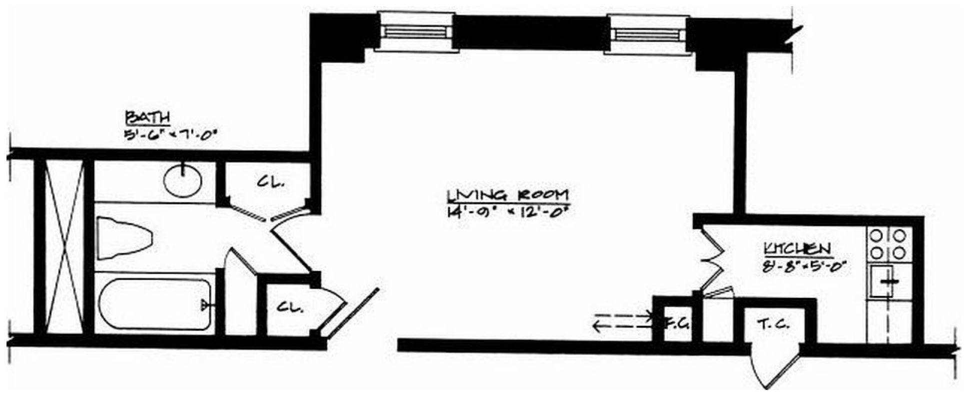

FIGURE 5-5: (Zillow)

Because Chicago is a clustered city primarily built upward with skyscrapers in the small city area of 237 square miles, it can be difficult to find a spacious apartment, especially at the higher living costs of residing downtown. However, you are also paying for the beautiful views that high-rise buildings have to offer and important amenities.

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

Within downtown Chicago, the common mode of commuting is the subway, which consist of eight lines, including the El train. The fare for a one-way trip on the subway is $3. By taking the subway from Lake View to the financial district in Chicago, the commute would take between thirty and forty minutes one way. From Lincoln Park to the financial district, the commute time on the subway would be less than half an hour.

XI. Where will you do your grocery shopping?

In Chicago, Mariano's and Jewel Osco are the popular local supermarket chains. There are also a variety of Trader Joe's and Targets throughout the city.

XII. How will you do your laundry?

Both apartments in Chicago that were previously mentioned feature an in-building laundry room as do many of the living spaces I researched throughout the city. The in-building laundry rooms would provide the convenience of carrying my laundry within a short distance.

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

There is a wide variety of Catholic churches available in Chicago, and I hope to get involved in one, such as Vincent de Paul Catholic Parish Church. Also, I would be interest in joining Alliance for the Great Lakes who recruits volunteers in Chicago to help clean the areas near Lake Michigan to reduce lake pollution and help the aquatic life in the lake. PAWS Chicago is another charitable organization that I would be interested in volunteering with. PAWS Chicago runs pet adoptions and foster programs in the city in addition to running spay and neuter initiatives to build a “no kill community”, and volunteers can help with tasks and operations at the adoption centers.

XIV. What are the sports, entertainment, or recreational activities that you would be most likely to engage in within the city?

With the variety of entertainment options in the city, I would be very interested in attending stand-up comedy shows, including Second City and iO Theater, where some notable comedians got their start. In addition, Chicago has a rich scene for live music, including jazz clubs, like Green Mill, and the Chicago Symphony Orchestra, both of which I would be enticed to go to. The city also features a vibrant culture for art, especially in its parks and museums, and I would like to explore the Art Institute of Chicago and the modern sculptures featured in Millennium Park. Since there are also accessible beaches along Lake Michigan, such as Montrose Beach, I would hope to participate in kayaking or paddleboarding and enjoy the natural aspects of the big city.

Ice skating at the McCormick Tribune Ice Rink is also a popular Chicago tradition that I would like to try to be entertained in the cold winter weather.

XV. 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?

The main modes of returning to my hometown from Chicago are by car, by train, or by plane. The drive from Chicago to St. Louis theoretically should take about four hours; however, the heavy traffic of down could increase the trip to about a six-hour drive. Meanwhile, it would also be possible to fly from either Chicago airport to St. Louis Lambert on a one-hour flight, but the price of a round-trip ticket costs between $200 and $300. The most practical mode to travel home would most likely be by train on a five-hour journey since Amtrak offers low one-way fares from Chicago Union Station to St. Louis at around $27.

XVI. 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.

FIGURE 5-6: Estimated Monthly Budget – Chicago

Monthly Salary ($60,000÷12)	$5,000.00
Income Taxes (for $60,000 salary, total annual income taxes = $13,950)	$1,162.50
Net Income	**$3,837.50**
Rent + Utilities	$1,350
Groceries	$200
Transportation Expenses	$250
Health Insurance	$300
Subscription Payments	$100
Recreation and Entertainment	$300
Personal Expenses	$300
Income left for savings and other	$1,037.50

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

After analyzing the aspects of living in both Los Angeles and Chicago, I would still want to be open to living and working in either city because both locations have the vibrant cultures of living in large, historical cities with many opportunities for personal growth and new experiences. Although both cities would be expensive to live in, I believe that it would be best for me to live there as a young and independent adult because I would have more financial freedom in my early years without having to consider the cost of raising a family. I would prefer to live in Los Angeles because I am already familiar with the city and its culture, and I have family there to support me, not only with possible housing but also for emotional support as I adjust to living full-time in Los Angeles. Furthermore, the warm climate of Southern California and the ease of access to beaches are appealing after living in the sometimes-unpredictable climates of both St. Louis and Oxford. In addition, I have been considering the entertainment and technology industries as potential options to work with in an accounting firm, and since Los Angeles is a major hub for both industries, I could learn a lot from being in the center of business.

CASE 6

Capitalized Costs — WorldCom, Inc.

Introduction

This case focused on the improper reporting of costs performed by WorldCom in 2001, specifically the company's incorrect capitalization of costs. The chief financial officer of WorldCom and his colleagues decided to reclassify certain costs under different items of financial statements in order to increase net income on the income statement, defying the interpretations of these items under FASB Statement of Concepts No. 6. FASB Statement of Concepts No. 6 (SCON 6) specifies the definitions for the elements of accounting, including assets and expenses. However, WorldCom disregarded the specific definitions of assets and expenses laid out by this concept in order to enhance the company's income to appease stockholders until business actually recovered, choosing to incorrectly capitalize some costs to defer expenses to a better period for business.

As an accounting student, learning about the improper accounting practices of WorldCom along with Arthur Andersen and Enron is important because a career in accounting requires increased standards for ethics as a result of the Sarbanes-Oxley Act and more accountability for ethical accounting methods. In addition, I was able to research and use FASB concepts in a practical manner to improve my understanding of the difference between capitalized costs and general expenses. Through the analysis of the improper accounting methods that WorldCom executives used to report their costs and income, I gained insight into the effects of understatement and overstatement of the inaccurately reported expenses and assets on the different financial statements for the result of an evidently material difference in net income. Learning about the events at WorldCom has highlighted the consequences of using poor accounting practices and has reinforced the importance of making ethical decisions in an accounting career.

I. **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.**

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

The FASB Statement of Concepts No. 6 defines an asset as an item acquired by a company from a prior transaction that will most likely have future financial benefits for the company. FASB SCON 6 characterizes an expense as a use of assets or a liability incurrence in the process of providing goods or services or performing other regular operating activities by the company.

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

Costs should be expensed when they are a part of normal, recurring operating activities; however, costs should be capitalized when they contribute to the value of fixed assets and are depreciated over the useful life of the asset.

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

After costs are initially capitalized, the costs are added to the value of the fixed asset to which they are attached, so the asset section on the balance sheet increases, and the operating expenses on the income statement decrease because the costs are moved from expenses to assets. Since capitalized costs are added to the value of an asset, this value will be depreciated over a period of time, so the depreciation expense of the asset with its capitalized costs will be reported as a periodic estimated depreciation expense on the income statement over time to follow the expense matching principle under GAAP.

III. 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 (in billions). Explain in your own words, what these "line costs" are.

For the year ended December 31, 2001, WorldCom reported line costs amounting to $14.739 billion, which comprised mostly of access and transport costs that were owed to local telephone companies.

WorldCom Journal Entry:

Line Costs Expense	14.739 billion	
Accounts Payable		14.739 billion

Since WorldCom purposefully understated line costs on their statement of operations in 2001, the total operating expense section was understated, resulting in an overstated net income. The overstatement of net income would cause retained earnings to be overstated on the balance sheet.

IV. 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 I above?

Scott Sullivan, the chief financial officer at WorldCom, made the decision to reclassify the costs of paying local telephone companies for calls to go through, known as line costs, charges that made up a great portion of operating expenses that WorldCom incurred. While these expenses would normally be classified as operating expenses that would significantly reduce operating income, Sullivan decided to list these costs under capital expenditures, hoping to defer these expenses to a future period when revenues might increase. These costs do not meet the definition of assets under SCON 6 since the charges would not provide real future economic benefits to WorldCom and do not add value to the current fixed assets of the company.

V. 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?

WorldCom Journal Entry:

Property, Plant, and Equipment	3.055 billion	
Line Costs Expense		3.055 billion

On WorldCom's balance sheet, these costs were classified under property and equipment, most likely in transmission or communications equipment. The costs appear on the statement of cash flows under the cash flows from investing activities as capital expenditures which had an outflow of cash of $7.886 billion in the year of 2001.

VI. 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.

Using the midpoint of the range for transmission equipment of 22 years as the useful life, the total depreciation expense of the capitalized costs in 2001 is $83,306,820.

$771,000,000 ÷ 22 = $35,045,455

($610,000,000 ÷ 22) × 9/12= $20,795,455

($743,000,000 ÷ 22) × 6/12= $16,886,364

($931,000,000 ÷ 22) × 3/12= $10,579,546

Total Depreciation Expense = $83,306,820

WorldCom Journal Entry:

Depreciation Expense	83.307 million	
Accumulated Depreciation		83.307 million

Since the lines costs were improperly capitalized to property, plant, and equipment, the depreciation expense in 2001 is overstated on the income statement and statement of cash flows, resulting in an overstatement of net cash provided by operating activities.

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

Income before income taxes, reported	$2,393,000,000
Add: Depreciation Expense	83,306,820
Less: Line Costs Expense	(3,055,000,000)
Loss before income taxes, adjusted	(578,593,180)
Add: Income Taxes	202,507,613
Add: Minority Interests	35,000,000
Net Income, adjusted	$(341,085,567)

The difference in net income is material with a difference between reported net income and adjusted net income of an approximately $1.842 billion overstatement.

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CASE 7

Financial Statements – Starbucks Corporation

Introduction

This case focused on the analysis of the various financial statements and notes to financial statements of Starbucks Corporation. In examining the financial statements, horizontal analysis was involved in judging variations between the financial records between the fiscal years of 2012 and 2013. First, the preparation of financial statements was discussed, including the responsibility of parties from Starbucks and external auditors. The major components of Starbucks' balance sheet were explored, from assets through liabilities and equity and their significance to the structure of Starbucks as a whole. For the income statement, revenues and expenses were examined and compared between 2012 and 2013, including the notable litigation charge that Starbucks incurred in 2013. The statement of cash flows was also reviewed to analyze the difference between cash flows and figures on income statement.

Through this case, I was able to dissect the contents in financial statements further than I had in previous courses. I learned how to use common-size financial statements to compare different items on the financial statements and their financial weight using their proportion of net revenues and net earnings. In addition, the notes to financial statements were useful to learn about the significance of Starbucks' 2013 litigation charge and how the nature of the charge impacted operating expenses rather than general and administrative expenses. I also was able to extend my knowledge of the role of auditors by reading the opinion letters of the auditors who examined Starbucks' financial statements. This case is beneficial to my career in accounting because I may work in the audit practice and will contribute to analyzing the financial statements of companies to ensure the records follow GAAP and align with regulations from the SEC.

I. What is the nature of Starbucks' business?

Starbucks conducts business and generates revenue through company-operated stores and licensed stores where Starbucks sells fresh food and beverages, packaged beverage products, and Starbucks brand merchandise. In addition, Starbucks receives income equity investees and interest revenue.

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

The financial statements that are commonly prepared for external reporting purposes include the income statement, balance sheet, statement of stockholder's equity, statement of cash flows, and statement of comprehensive income. Starbucks calls the income statement the "Consolidated Statement of Earnings." "Consolidated" means that the financial information of a parent company and its subsidiaries are combined in financial statements that give an overall view of the company.

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

Publicly traded corporations prepare four financial statements for external reporting each year including quarterly reports, called 10-Qs, and a yearly statement, a 10-K.

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

The management of the company is responsible for preparing the financial statements. Investors, such as stockholders in Starbucks common stock, would be potential users of the financial statements, particularly net earnings and cash flow, because they would want to evaluate whether the company will provide returns on their investments. Regulatory bodies also examine the financial statements to ensure that the information is accurate, so investors are protected. Creditors of Starbucks, including banks and institutions that have lent money, use information such as the company's long-term debt, liquid assets, and cash flows to determine if Starbucks can pay back their debt or approve them for future lending. Management uses financial statements to determine their future strategy for the company. In addition, competitors of the company might use information in the statements to compare their revenues and costs to that of Starbucks.

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

Starbucks' external auditors are Deloitte & Touche LLP. The first "opinion" letter that Starbucks received states that the financial statements of Starbucks and its subsidiaries for 2013 were audited by Deloitte and satisfied the legal requirements and conformity to GAAP established for the financial statements, presenting the financial state of the company without material inaccuracy. The second "opinion" letter states that the internal control of Starbucks has been audited, the company's process of ensuring that financial reporting is prepared with reliability and accuracy and is in compliance with regulations. Both opinions are dated several months after Starbucks' year-end because Starbucks cannot complete financial statements until the fiscal year ends on September 29, 2013 when all financial information for the year is accessible, and auditors need time after receiving the financial statements from Starbucks to perform the full audit.

VI. Use a spreadsheet to construct common-size income statements (which Starbucks calls statements of earnings) and balance sheets for 2013 and 2012.

Consolidated Statements Of Earnings (USD $)	12 Months Ended			
In Millions, except Per Share data, unless otherwise specified	**Sep. 29, 2013**		**Sep. 30, 2012**	
Net revenues:	'		'	
Company-operated stores	$11,793.20	79%	$10,534.50	79%
Licensed stores	1,360.50	9%	1,210.30	9%
CPG, foodservice and other	1,738.50	12%	1,554.70	12%
Total net revenues	14,892.20	100%	13,299.50	100%
Cost of sales including occupancy costs	6,382.30	43%	5,813.30	44%
Store operating expenses	4,286.10	29%	3,918.10	29%
Other operating expenses	457.2	3%	429.9	3%
Depreciation and amortization expenses	621.4	4%	550.3	4%
General and administrative expenses	937.9	6%	801.2	6%
Litigation charge	2,784.10	19%	0	0%
Total operating expenses	15,469	104%	11,512.80	87%
Gain on sale of properties	0	0%	0	0%
Income from equity investees	251.4	2%	210.7	2%
Operating income	-325.4	-2%	1,997.40	15%
Interest income and other, net	123.6	1%	94.4	1%
Interest expense	-28.1	0%	-32.7	0%
Earnings before income taxes	-229.9	-2%	2,059.10	15%
Income taxes	-238.7	-2%	674.4	5%
Net earnings including noncontrolling interests	8.8	0%	1,384.70	10%
Net earnings attributable to noncontrolling interest	0.5	0%	0.9	0%
Net earnings attributable to Starbucks	$8.30	0%	$1,383.80	10%
Earnings per share – basic	$0.01	0%	$1.83	0%
Earnings per share – diluted	$0.01	0%	$1.79	0%
Weighted average shares outstanding:	'		'	
Basic	749.3	5%	754.4	6%
Diluted	762.3	5%	773	6%
Cash dividends declared per share	$0.89	0%	$0.72	0%

FIGURE 7-1: Starbucks Corporation Common-size Income Statements

Consolidated Balance Sheets (USD $) In Millions, unless otherwise specified	Sep. 29, 2013		Sep. 30, 2012	
Current assets:				
Cash and cash equivalents	$2,575.70	22%	$1,188.60	14%
Short-term investments	658.1	6%	848.4	10%
Accounts receivable, net	561.4	5%	485.9	6%
Inventories	1,111.20	10%	1,241.50	15%
Prepaid expenses and other current assets	287.7	2%	196.5	2%
Deferred income taxes, net	277.3	2%	238.7	3%
Total current assets	5,471.40	48%	4,199.60	51%
Long-term investments	58.3	1%	116	1%
Equity and cost investments	496.5	4%	459.9	6%
Property, plant and equipment, net	3,200.50	28%	2,658.90	32%
Deferred income taxes, net	967	8%	97.3	1%
Other assets	185.3	2%	144.7	2%
Other intangible assets	274.8	2%	143.7	2%
Goodwill	862.9	7%	399.1	5%
TOTAL ASSETS	11,516.70	100%	8,219.20	100%
Current liabilities:				
Accounts payable	491.7	4%	398.1	5%
Accrued litigation charge	2,784.10	24%	0	0%
Accrued liabilities	1,269.30	11%	1,133.80	14%
Insurance reserves	178.5	2%	167.7	2%
Deferred revenue	653.7	6%	510.2	6%
Total current liabilities	5,377.30	47%	2,209.80	27%
Long-term debt	1,299.40	11%	549.6	7%
Other long-term liabilities	357.7	3%	345.3	4%
Total liabilities	7,034.40	61%	3,104.70	38%
Shareholders' equity:				
Common stock	0.8	0%	0.7	0%
Additional paid-in capital	282.1	2%	39.4	0%
Retained earnings	4,130.30	36%	5,046.20	61%
Accumulated other comprehensive income	67	1%	22.7	0%
Total shareholders' equity	4,480.20	39%	5,109	62%
Noncontrolling interests	2.1	0%	5.5	0%
Total equity	4,482.30	39%	5,114.50	62%
TOTAL LIABILITIES AND EQUITY	$11,516.70	100%	$8,219.20	100%

FIGURE 7-2: Starbucks Corporation Common-size Balance Sheets

VII. Refer to Starbucks' balance sheet for fiscal 2013.

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

Starbucks' major assets include property, plant, and equipment, cash and cash equivalents, inventories, short-term investments, deferred income taxes, and goodwill. The proportion of short-term assets, labeled as current assets on the balance sheet, to total assets for 2013 is 48% while the proportion of long-term assets is 52%. The proportion of short-term assets to long-term assets seems appropriate for Starbucks because the items that compose the greatest proportion of total assets are property, plant, and equipment, cash, and inventory, each of which are essential to Starbucks' business of food production and retail store sales.

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

Intangible assets are nonphysical assets. Goodwill is an intangible asset that a company only recognizes when it acquires another business and represents assets such as company reputation that are hard to quantitatively identify. Starbucks might have intangible assets such as indefinite-life trade names and trademarks that distinguish the Starbucks brand, and definite-life trade secrets, patents, and copyrights.

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

Starbucks is financed through short-term liabilities, long-term debt and equity from common stock. The proportion of total financing that comes from non-owners is 61% which is the proportion of total liabilities in total liabilities and equity.

VIII. Refer to Starbucks' statement of earnings for fiscal 2013 and to the common-size income statement you developed in part VI, above.

- **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? 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?**

For company-operated stores, Starbucks recognizes revenue at the point of sale when payment is taken from customers. However, sales of Starbucks products in licensed stores are recognized when they are shipped to licensees, and the shipping cost billed to the licensees is also recorded as revenue. For stored value cards such as gift cards, Starbucks records revenue when the gift card is redeemed by the customer or when the gift card is likely to be deemed remote, based on the historical inactivity of the card. Some challenges in measuring revenue may fall in the inconsistency of at what point in time Starbucks collects revenue from its customers because there are differences between Starbucks recognizing revenue at shipment for licensed stores and recording revenue when products are received by the customers of packaged goods. Management might need to make the judgment to use a consistent method for revenue recognition for all types of transactions, for company-operated stores, licensed stores, and other customers.

- **What are Starbucks' major expenses?**

Starbucks' major expenses include cost of goods sold, store operating expenses, general and administrative expenses, depreciation and amortization expenses, and a litigation charge in 2013.

- **Were there any significant changes in the cost structure during the most recent year?**

In the most recent year, Starbucks changed the reporting of some indirect overhead costs including indirect merchandising, manufacturing, and back-office shared service costs. Instead of allocating the costs by segment as done in the past, they are now included as unallocated corporate expenses, resulting in prior period adjustments to adjust financial statements, specifically the statements of earnings.

- **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?**

The company did not include the amount in general and administrative items because it was a significant and non-recurring expense as no litigation charge was listed in the 2012 statement of earnings. The litigation charge is considered to be an operating expense because it resulted in an effect on continuing operations due to a discontinued deal with Kraft Foods Group, Inc.

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

During 2012, Starbucks was profitable, earning $2,059.10 million before income taxes and $1,384.70 million net earnings including controllable interest. During 2013, Starbucks was not profitable because although it earned $8.8 million of net income including controllable interest, the company faced a loss of $229.9 million before income taxes were applied. "Profitable" means that the revenues earned by a company are greater than the expenses it incurs, and in 2013, Starbucks incurred a greater amount of expenses than revenues and only achieved a positive net earnings amount through negative income taxes.

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

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

During 2013, the net earnings were listed as $8.8 million while the net cash provided by operating activities is stated as $2,908.3 million. The difference may come from the litigation charge which significantly reduced net earnings on the income statement, but the litigation charge was most likely an accrual and not paid for with cash in 2013, so the charge would not impact the cash used by operating activities.

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

Starbucks spent $1,151.2 million with cash on property, plant, and equipment.

- **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?**

Starbucks paid $628.9 million of cash dividends during the year. On the statement of equity, the amount of dividends declared is recorded as $543.7 million in 2013. The difference between these two amounts may be explained by the possibility that Starbucks was paying off dividends declared during the previous period.

X. 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?

Estimates would be required on the balance sheet for accounts including short-term investments, inventory, prepaid expenses, net accounts receivable due to the allowance for doubtful accounts, property, plant, and equipment due to depreciation and useful life estimations, long-term investments that may be impaired, equity and cost investments, goodwill, other intangible assets, deferred income taxes, insurance reserves, deferred revenue, long-term debt, retained earnings, and accumulated comprehensive income. Cash and cash equivalents and accounts payable are most likely accounts that are estimate-free because the assets are held for shorter periods of time and are easier to measure. In addition, common stock and additional paid-in capital could be estimate-free.

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CASE 8

Contingent Liabilities – BP p.l.c.

Introduction

The purpose of this case was to examine BP, the oil and gas company, and the effects of the 2010 Deepwater Horizon oil spill in the Gulf of Mexico. As a result of the damage caused by the oil spill, through the crew members lost in the fire and the environmental impact, BP faced thousands of claims and a great deal of litigation. The purpose of this case was to examine how contingent liabilities, including warranties and litigation, are handled from an accounting perspective. Estimates are required in the accounting of contingent liabilities because the liabilities are not fully realized unless specified events occur in the future, so there is a great amount of uncertainty in handling these liabilities, especially in valuing their amount. In determining estimates for litigation, auditors must consider many factors that could contribute to the costs of litigation and how likely those factors are to occur. Auditors should determine whether litigation claims have merit because it will impact the likelihood of the company needing to pay.

Through this case, I was able to consider contingent liabilities and warranties in a more detailed perspective beyond what is taught in core accounting classes. In addition, I stepped into the position of an auditor for BP during the time period following the oil spill to analyze the impacts of the incident on the financial state of BP. The knowledge I gained through this case and the critical thinking I needed to determine the effects of the oil spill on BP will be beneficial to my career in accounting because there are many situations in accounting that will not have clear answers. In determining the estimates of contingent liabilities, there is a lot of uncertainty, and there are various items in financial statements that require estimates due to lack of concrete information. It is the job of auditors to determine whether estimates are reasonable.

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

A contingent liability is a liability whose realization and complete details depend on future events and whether they actually occur or not. A company should record a contingent liability on its books when it is probable that the liability will occur and the cost of the liability is reasonably estimated. Contingent liabilities include asset retirement obligations, warranties, and pending litigation. Companies typically do not record contingent assets; instead, they disclose a contingent asset in notes to financial statements when there is a high probability of realizing it.

II. 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 the perspective of BP, a product warranty for the telescopic joint is a guarantee of quality for the equipment and assures that any defects in the telescopic joint can be fixed by GE Oil and Gas if BP makes a claim. Its cost is included in that of the telescopic joint, so it is not recorded separately in journal entries or financial statements. From the perspective of GE Oil and Gas, the seller, a warranty for the sold equipment would be a liability and performance obligation to BP. GE Oil and Gas would record warranty expense during the period when the equipment is sold to cover estimated warranty-related costs to be incurred, even if no claims are made during that period, and warranty liabilities to estimate for future costs.

III. 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 accounting for contingent liabilities in general, management must consider the probability of the liability occurring and how much the liability will likely cost, based on historical information and other factors. For accrued warranty costs in particular, the historical likeliness of customers to make claims and previous costs the company has incurred in fixing warranty claims should be considered to estimate the warranty expense. A claim for damage from the Deepwater Horizon oil spill would be different from a warranty claim on a telescopic joint because the warranty because there is a lot more uncertainty in determining the cost of damage from the Deepwater Horizon than with a warranty claim on a telescopic joint. With a warranty claim on a piece of equipment, the company will have a better estimate of expenses due to previous experience with warranty-related costs. However, the oil spill would be considered an unusual and potentially unexpected event, so BP may not have prepared for the type or amount of damages that people or organizations may claim for. A claim for damages may also differ from a warranty claim because auditors must determine whether the claim is reasonable or not to determine if it should be recorded in financial records. There are many factors that auditors must consider in estimating if a claim will result in an actual financial impact and how significant the impact will be. However, a warranty claim is more predictable and there is less uncertainty about how it can impact the company.

IV. 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.

To determine the contingencies associated with the Deepwater Horizon oil spill, some of the estimates that BP must make are related to litigation-based legal costs that are expected, payments to the escrow account, penalties and fines due to the Clean Water Act, US Coast Guard and shoreline response costs, decontamination of vessels, and natural resource damage under the Oil Pollution Act 90. The litigation costs may from litigation claims by governmental, environmental groups, and families of the workers harmed during the explosion. The penalties under the Clean Water Act can be estimated based on flow rate of oil based on historical rates provided, and they are adjusted based on BP's assertion that the company was not "grossly negligent" in their conduct surrounding the cause of the oil spill. The estimates for decontamination of vessels relate to costs that BP had already incurred by the time of preparing the financial statements and the related transactions that are expected to happen in the future.

V. If you were the auditor for BP and working with the lawyers for a contingent liability estimate, think of the potential people that could sue. Is it reasonable or not for them to sue? How do events affect the accrual of contingent liabilities?

There are many potential individuals and organizations that could bring litigation against BP, and auditors must consider the probability of litigation claims resulting in payments. One group that most likely has reasonable claims against BP is the families of the workers who were killed in the Deepwater Horizon oil spill and the workers who were injured. These individuals could file civil lawsuits for the loss of their loved ones, payment of medical bills, or compensation for wages lost due to injuries. In addition, the residents of the coastal towns and the oil spill clean-up workers could potentially make claims for health and safety issues. It may be reasonable for the clean-up workers and certain residents of the coastal towns to sue BP if they show proof of the oil spill's legitimate impact on their health and safety, such as illness, or even show BP's failure to take actions that should have been taken to improve safety. As an auditor for BP, it is important to consider how long the clean-up of the oil spill might take and what future safety issues may arise later after the oil spill. Another group that would be impacted by the cleanup of the coasts is the tourism industries of the coastal towns in Louisiana, Mississippi, Alabama, Florida, and Texas. These towns may have a reasonable argument if they can give proof that the oil spill significantly damaged the typical revenues or losses of their tourism industries. To determine the contingent liability amount and likelihood, it is necessary to compare the current and historical financial records of the towns and states to examine the level of impact and analyze details that could indicate the differences were actually a direct result of the oil spill damages. Auditors should also think about the residual damage from the oil spill that could damage the tourism industries in this area such as continued clean-up or construction to address the problems of the oil spill. Business owners and significant members of the fishing and seafood industries may also have reason to file litigation claims. Many of these groups that actually source their fish and seafood from the Gulf of Mexico could have legitimate claims because their resources would be contaminated by the oil spill. These resources may be either tainted or even killed in the oil or from the actions taken to stop and clean the spill, so the supply of fish and seafood is reduced for the businesses in this industry. The probability of these claims resulting in actual settlements depends on whether the businesses actually conduct a great deal of fishing in the areas affected by the oil spill and whether the amount of seafood they are able to collect was impacted by it. Some seafood businesses may try to make a claim even if only a small portion of their inventory comes from the affected areas in the Gulf of Mexico or their resources were not significantly hurt. Environmental groups, such as National Fish and Wildlife Foundation and National Academy of Sciences, also could file claims against BP to provide funding for restoration of the habitats impacted by the oil spill and any other damage that spread and hurt wildlife. For these claims, auditors should evaluate the costs of what equipment and labor may be needed to restore the areas. Finally, other oil companies could potentially sue BP because there was a ban imposed on offshore drilling in the U.S. after the oil spill, which could impact business opportunities of the other oil companies and create losses. These claims may not be as valid as other claims because the oil companies have more to prove in exhibiting to courts how the oil spill hurt their financial wellbeing.

CASE 9

Equity Method – The Wendy's Company

Introduction

The primary focus of this case was the joint venture between fast food companies Wendy's and Tim Hortons. The joint venture, called TimWen, is treated as if Wendy's had a significant or controlling interest in the company since Wendy's has a fifty percent share of the joint venture. Because Wendy's has significant or controlling interest in Tim Hortons, they must use the equity method to account for the value of their shares. This case examines the use of the equity method by investors and how they impact an investor's financial information. The financial statements of Wendy's in 2011 and 2012 were analyzed for the effects of the equity method on different items in the income statement, balance sheet, and statement of cash flows.

While researching for this case, I was able to enhance my understanding of the equity method and examine how investments treated under the equity method affect financial statement information. Although I had previous knowledge of the equity method, I learned about the accounting for goodwill associated with equity investments and acquisition accounting premiums. This analysis conducted in this case will be useful to my career in accounting because it is important to distinguish between equity investments that result in little influence and those that carry significant influence. Different methods of accounting are used to adjust the values of these different investments, with the equity method used for significant interest and the fair value method used for little to no interest. The differences between these methods have different effects on each of the primary financial statements including the income statement, balance sheet, and statement of cash flows, so it is important to understand these differences as an accountant preparing or auditing financial statements.

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

Companies enter into joint-venture agreements because they may want to expand their business to a new market while sharing the risks and benefits with another company. Many companies enter into joint ventures in order to start business in a foreign country although they may not want to take the responsibility of the risks of expanding in a new country on their own. Wendy's may have decided to enter into a joint venture with Tim Hortons because Wendy's operates in the United States while Tim Hortons has a strong hold in Canada, so Wendy's could improve their business in Canada.

II. Consistent with U.S. GAAP, Wendy's uses the equity method to account for its joint venture in TimWen. Briefly explain this accounting method.

The equity method is used by companies who have significant influence or controlling influence through investments in another company. Investors with significant influence typically own twenty to fifty percent of the investee's equity securities, and investors with controlling interest own at least fifty percent of the investee's equity securities. The equity method is used instead of the fair value method used for investors with little to no influence because investors with significant or controlling influence have an actual financial relationship with the investee company where the investee's earnings and losses impact the value of the investor's share of net assets. Investors who use the equity method initially record their investment at the amount they purchased it for and periodically adjust the amount of the investment by their share of the investee's earnings or losses, based on their percentage of ownership, and by dividends received. When the investor makes the initial investment, the "Equity Investments" account is debited for the amount that was spent on the investment, and cash or another method of payment is credited for the equal amount. When the investee reports positive income at the end of a period, the investor debits Equity Investments for the proportion of the investee's income corresponding to the percent of shares the investor owns and credits "Equity Income" for that amount. This increases the value of the Equity Investment account. However, if the investee reports a loss, the investor must credit "Equity Income" and debit "Equity Investments" for their proportion of the loss amount, decreasing the total amount in Equity Investments. This entry reverses the effects of the entry to record the investor's share in investment income. When receiving dividends, the investor should debit "Cash" for the amount of dividends received and credit Equity Investments, thus decreasing the overall amount in that account.

III. 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?

The investment amount may exceed the investor's share of book value of the net assets of the investee because some of the investee's assets and liabilities need to be adjusted to fair value or the investee may have goodwill, an intangible asset that accounts for values of a company that are hard to value. Goodwill is only recorded upon acquisition of another company, so Wendy's would report the goodwill from investing in Tim Hortons on their financial statements while Tim Hortons would not report that goodwill. Net assets, also recognized as equity, is equal to the difference between the book value of the investee's assets and that of their liabilities. The difference between the investment amount and the investor's share of the book value is known as the acquisition accounting premium (AAP). When accounting for the excess amount for this difference under the equity method, the investor's share of the book value of the net assets must first be determined by multiplying the total net asset value by the investor's proportion of ownership. Then, the value of the investor's share of net assets must be written up to its fair value at the time of the acquisition by determining the fair value of the separate assets and liabilities of the investee. If the purchase price of the investment still exceeds the value of the net assets marked up to fair value, the remainder of the investment purchase price is assigned to goodwill. Under GAAP, goodwill is not typically amortized although it must be annually tested for impairment to adjust it to fair value. However, under the equity method, an annual charge must be made by the parent company, Wendy's in this case, to record amortization of purchase price adjustments. A journal entry to record the amortization of the AAP would include a debit to equity income and a credit to equity investments which essentially reverses some equity income that was previously earned.

IV. 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 the 2012 balance sheet, Wendy's reported $87,620 thousand for their equity method investments, and in the 2011 balance sheet, $91,819 thousand was included. These amounts are composed of the sum of the carrying values of the equity investments in Tim Hortons and Japan. In 2011, these investments are included in "Investments" under assets on the consolidated balance sheet, but in 2012, only Wendy's investment in TimWen is included in "Investments" while their investment in Japan is included in "Other liabilities" due to their 2012 loss from the joint venture.

V. 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?

Wendy's investment in TimWen at December 30, 2012 is reported as $89,370 thousand while Wendy's fifty percent share of TimWen's equity at this date is $35,283 thousand. The $35,283 thousand is calculated by multiplying the value of net assets of TimWen in the TimWen balance sheet, $70,565 thousand, by Wendy's fifty percent share of TimWen's equity. The difference between these two amounts is the result of the acquisition accounting premium which is the difference between the investment value and the Wendy's proportion of the book value of the net assets. Part of the acquisition accounting premium is due to goodwill of TimWen, and part is due to the write-up of net assets to fair value.

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

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

In 2012, Wendy's equity method investment in TimWen increased their earnings before taxes by $10,551, the difference between the equity in earnings in TimWen of $13,680 thousand and the purchase price adjustment amortization of $3,129 thousand. In 2011, the investment increased their earnings before taxes by $10,571 thousand, the difference between equity in earnings of $13,505 thousand and purchase price adjustment amortization of $2,934 thousand. In the consolidated statements of operations, these amounts are reported in "Other Operating Expenses, net."

- **Prepare the journal entry to record Wendy's share of TimWen's 2012 earnings (in thousands).**

To find Wendy's share of TimWen's 2012 earnings, the "Income before income taxes and net income" in the TimWen income statement information is multiplied by Wendy's fifty percent investment in Tim Hortons.

$27,377 thousand × 50% = $13,689 thousand

Equity Investments	13,689 thousand	
Equity Income		13,689 thousand

- **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 (in thousands).**

In the Note 8 section on the TimWen joint venture, the amount of amortization of the purchase price adjustments in 2012 is $3,129 thousand. This amount is based on an average original aggregated life of 21 years.

Equity Income	3,129 thousand	
Equity Investments		3,129 thousand

- **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 thousands).**

According to the item "Distributions received" in the first table under the section in Note 8 that describe the TimWen joint venture, Wendy's received dividends of $14,942 thousand in 2011 and $15,274 thousand in 2012.

Cash	15,274 thousand	
Equity Investments		15,274 thousand

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

- **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.**

In the Note 8 section "Investment in Joint Venture with Tim Hortons Inc.", the first table describes some of the financial activity related to Wendy's investment in Tim Hortons. The first subtotal in the table under 2012 is $10,551 thousand which is the difference between the equity in earnings for 2012 of $13,680 thousand and the amortization of purchase price adjustments of $3,129 thousand, calculated using an average life of twenty-one years. In the section "Investment in Joint Venture in Japan," Wendy's reported an equity in losses in 2012 of $1,827 thousand associated with their investment in Japan. The sum of the $10,551 thousand equity in earnings for TimWen and the $1,827 thousand loss equals $8,724 thousand as their total earnings from all joint ventures, which reconciles with the $8,724 thousand reported as "Equity in earnings in joint ventures, net" on the statement of cash flows. A negative adjustment is made to arrive at net cash from operating activities because Wendy's is not actually receiving cash from the equity income that is recorded under the equity method when the investor adjusts the value of their investment by their proportion of the investee's net income. Although the investment income is reported on the income statement, it must be subtracted from net income on the statement of cash flows since it does not involve cash.

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

In the first table under "Investment in Joint Venture with Tim Hortons" in Note 8, the distributions received in 2012 is reported as a negative $15,274 thousand which are the dividends paid to Wendy's. This amount is negative in this table because under the equity method, dividends reduce the balance of equity investments when paid. There are no distributions received from Wendy's investment in Japan in 2012. The $15,274 thousand in dividends received from TimWen is equal to the $15,274 thousand reported in "Distributions received from joint venture" on the statement of cash flows. A positive adjustment is made in the operating section because dividends under the equity method are made as an adjustment to the equity investment account rather than investment income, so the cash dividends for the joint venture are not included in net income. Therefore, the cash dividends received from Wendy's investment in TimWen need to be added back to net income on the statement of cash flows.

CASE 10

Retirement Obligations – Johnson & Johnson

Introduction

This case required an analysis of retirement obligations and pension plans, focusing on these items in the context of Johnson & Johnson's financial statements. Various components are considered in determining the value of projected benefit obligations and retirement plan assets, and pension expense is composed of multiple items that can be probed separately. In addition, the pension process was explored, including the various organizations and individuals involved and the flow of cash between these entities. Employers, employees, and pension fund management have different roles in the process of pension funding and the payment of pension benefits. Although the accounting for pension obligations and plan assets is carefully determined, there may be many variances in the values of these items and the accounting for these differences is discussed.

In this case, I expanded my knowledge of accounting for pensions by analyzing the components of projected benefit obligations and plan assets in more detail. This case provided the individual steps of accounting for pension expense, pension obligations, and plan assets to provide clarity of the pension process. The information in this case and the evaluation of pensions will be beneficial to a career in accounting because pensions are often based on estimates and assumptions, and estimates and assumptions sometimes must be made when there is uncertainty with various financial items. It was also useful to examine the notes to financial statements that elaborate on items in primary financial statements because these are necessary in auditing. By focusing on an individual item on the financial statement in detail through notes, I was able to understand more about what factors are involved in pension accounting.

I. **There are two general types of retirement plans—defined benefit plans and defined contribution plans.**

- **How do these two types of plans differ? Which type does Johnson & Johnson have?**

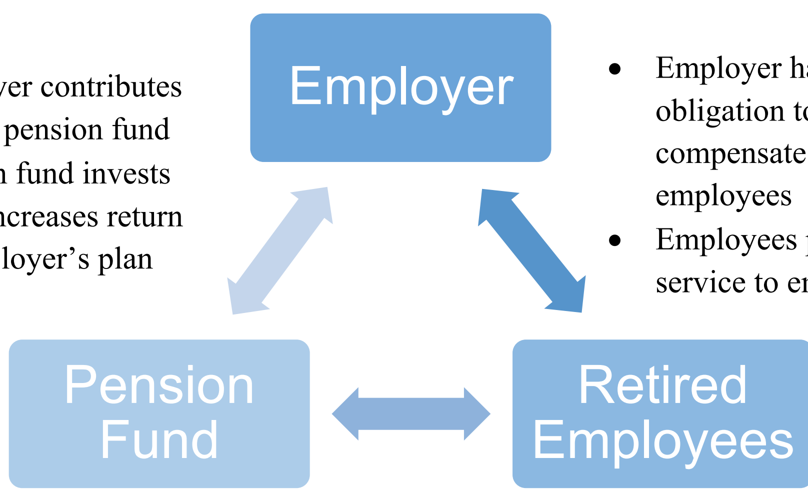
A defined benefit plan provides a predetermined, specified amount of the annual benefits that employees will receive, and the employer's annual contribution to the plan may change each year. Meanwhile, a defined contribution plan requires the employee and the employer to make contributions to the plan each year in fixed amounts. Johnson & Johnson has both defined benefit and defined contribution plans.

- **Explain why retirement plan obligations are liabilities.**

Retirement plan obligations are liabilities because they are obligations to compensate employees with benefits that will be paid in the future due to the employees' service to the company, which can also be viewed as a prior transaction between the employer and employees.

- Employer contributes cash to pension fund
- Pension fund invests cash- increases return on employer's plan assets

- Employer has obligation to compensate retired employees
- Employees provide service to employer



- Employees contribute cash to pension fund (defined contribution)
- Pension fund distributes cash benefits to employees

FIGURE 10-2: Pension Process Flow Chart

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

Some of the assumptions that are needed to determine projected benefit obligations include the expected return on investments, how long employees will live and the length of their service time of the company, change in salaries, and any interest rates. Actuaries use these factors to make assumptions in determining the projected benefit obligation.

II. 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.

The service cost aspect of the pension obligation is the amount of benefits earned by employees for each additional year of service they provide to the company. Service cost increases pension expense. Interest cost is the interest accrued on the pension obligation since it is a growing liability that is not immediately paid for. It is based on the beginning balance of projected benefit obligation in a year and any prior service costs added and increases pension expense. Actuarial gains or losses are the assumptions that actuaries make to calculate if the fair value of the pension obligation has changed. These can either increase or decrease pension expense. Benefits paid to retirees are the cash payments that the pension fund distributes to retired employees, decreasing the pension obligation.

III. 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.

The actual return on pension investments is the amount of interest and dividends that are earned from and any changes in fair value of the plan investments, increasing the overall value of the plan assets. Company contributions to the plan are the cash payments made by the company to the pension fund to increase the value of plan assets. The benefits paid to retirees are the cash payments made to retired employees. These payments are made by the pension fund rather than the company itself and decrease both pension assets and the projected benefit obligation.

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

In pension expense, the expected return on plan assets is subtracted from pension expense because the company anticipates that this amount will be earned on plan assets, thus reducing the amount that the company will need to contribute to properly fund the pension obligation. In calculating the fair value of plan assets, the actual return is added to plan assets; this is the amount by which the plan assets actually increased and may be different from the expected return due to unexpected changes in fair value of the plan assets. To reconcile the actual return and the expected return, the difference between the two values is reported as a gain or a loss in other comprehensive income.

V. Consider Johnson & Johnson's pension expense. Note that the company uses the term "net periodic benefit cost" to refer to pension expense.

- **How much pension expense did Johnson & Johnson report on its 2007 income statement?**

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

- **Prepare the journal entry to record the service cost and interest cost portion of the 2007 pension expense (in millions).**

The service cost was reported as $597 million in 2007 and the interest cost was $656 million, for a total of $1,253 million.

Pension expense	1,253 million	
Projected Benefit Obligation		1,253 million

VI. Consider Johnson & Johnson's retirement plan obligation.

- **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, 2007, the value of the company's retirement plan obligation is $12,002 million. This value represents the benefits that Johnson & Johnson will pay to retired employees. This number is fairly reliable because it is calculated by actuaries using carefully determined assumptions and estimations.

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

The pension-related interest cost for 2007 is $656 million. The interest cost is computed by multiplying the value of the projected benefit obligation by the settlement rate. To calculate this settlement rate for interest cost, the interest cost must be divided by the beginning value of the projected benefit obligation, $11,660 million. Since amendments of $14 million have been made for prior service costs in 2007, this value must be added to the beginning projected benefit obligation. This calculation results in a settlement rate of 5.62 percent.

$$\$11{,}660 \text{ million} + \$14 \text{ million} = \$11{,}674 \text{ million}$$

$$\$656 \text{ million} \div \$11{,}674 \text{ million} = 5.62\%$$

This settlement rate seems reasonable because Johnson & Johnson reports in the notes to its financial statements that the average discount rate of the U.S. benefits plans is 6.5 percent, and the average rate for international benefit plans is 5.5 percent, and the calculated rate of 5.62 percent is within this range.

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

The amount of pension benefits that were paid in 2007 is $481 million. Johnson & Johnson does not pay cash for these benefits because the payments come from the plan assets, under the responsibility of the pension fund. The payment of benefits decreases both the projected benefit obligation and the plan assets.

VII. Consider Johnson & Johnson' retirement plan assets.

- **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 is $10,469 million which is the fair value of the assets.

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

The amount of the expected return in 2006 was $701 million which is $265 million less than the actual return of $966 million. In 2007, the expected return was $809 million while the actual return was $743 million, $66 million less than the expected return. In 2007, the difference is 8.2 percent of the expected return which can be considered insignificant, but the difference in 2006 is 37.8 percent of expected return, a significant difference. The corridor approach could also be used to determine if the gain or loss on the plan assets if significant enough that it should be amortized by taking ten percent of the larger value of the beginning balance of the projected benefit obligation or plan assets, multiplied by ten percent and comparing it with the difference between expected return and actual return. The actual return better reflects the economics of the pension expense because it is the amount that the company really earns on its plan investments, affecting the underfunded or overfunded status of the pension fund that influences how much the company should contribute.

- **How much did Johnson & Johnson and their employees contribute to the retirement plan during 2007? How does that compare to contributions in 2006?**

In 2007, Johnson & Johnson contributed $317 million to the retirement plan while employees contributed $62 million for a total of $379 million. This amount is $83 million greater than the total contribution in 2006 of $296 million when the company contributed $259 million and employees contributed $47 million.

- **What types of investments are in Johnson & Johnson's retirement plan assets?**

Johnson & Johnson's retirement plan assets for U.S. retirement plans are composed of investments in equity securities and debt securities, and the international plan assets are invested in equity and debt securities along with real estate and other investments.

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

At the end of 2007, the retirement plan is underfunded by $1,533 million, and the plan is underfunded by $2,122 million at the end of 2006. On the balance sheet, this funded status appears under liabilities in the item "employee related obligations."

CASE 11

Comparison of the Balance Sheet and Income Statement Approaches

Introduction

This case examines the opinions expressed in the essay "On the Balance Sheet-Based Model of Financial Reporting" by Ilia D. Dichev and Stephen Penman. In this essay, the authors discuss the weaknesses of the balance sheet approach to accounting favored by FASB and why the income statement approach that has been historically preferred in accounting is more useful for the majority of modern businesses. Although the income statement concept was the primary ideology used before the later part of the twentieth century, it is not frequently discussed in modern accounting or in university accounting coursework, so it may challenge newcomers to the accounting industry to think about financial reporting and the different components of accounting in a different light from the current balance sheet method. However, the income statement view has merit and the ideology behind it can potentially be used in practice.

Through the consideration of the information and opinions in this essay, I discovered the benefits to income statement approach to accounting over the balance sheet approach. Since the balance sheet concept is the primary foundation for the accounting courses that I am currently taking or have taken, I had not considered thinking about accounting concepts from the point of income statement items. It was helpful to gain a new perspective on the role of assets, liabilities, and earnings in business processes and financial conditions. Although I believed that assets were the most appropriate measurements for adding value in business, the authors of this essay were persuasive in arguing for usage of income statement items as the primary method for measuring value in businesses. This information and opinions that I contemplated in this case could be valuable to my career in accounting in determining valuation of financial items.

Article Summary

In the article, “On the Balance Sheet-Based Model of Financial Reporting,” Dichev and Penman discuss the advantages of using the income statement approach to accounting compared to the balance sheet approach. The balance sheet view focuses on presenting value in financial reporting for businesses through assets and liabilities rather than earnings and is currently preferred by accounting regulatory organizations including FASB. On the other hand, the income statement method places emphasis on presenting value created by businesses through revenues, expenses, and profits while assets and liabilities are merely supportive resources in business processes.

Dichev and Penman argue that the balance sheet approach is not appropriate for most businesses and their processes since the purpose of many businesses is to use expenses to generate revenue and earnings. While the balance view is useful for representing value through the growth of assets such as in investment firms where assets have “value-in-exchange”, most businesses use or transform assets as temporary resources with “value-in-use” to produce the ultimate goal of revenues and earnings. Assets may be disposed of when a company ends its business, but earnings remain to reflect the operations of the business. In addition, managers involved in managerial accounting are more likely to use revenue and expenses to plan for business functions in the future before analyzing the value and usage of assets and liabilities. Also, investors and financial analysts are likely to first look to the information in the income statement for understanding a firm’s economic wellbeing.

Furthermore, the essay asserts that the balance sheet approach has unclear advantages to the income statement approach. The authors point out that FASB’s definition of assets refers to "future economic benefits" that often depend on earnings, so the income statement view is still essentially relied on for giving value to the balance sheet approach. Additionally, the concept of income is clearer to almost anyone for any business for understanding the economic health of a company while value in balance sheet items may not be as indicative of wealth to those unfamiliar with accounting.

The essay discusses how the balance sheet view is reducing the usefulness of earnings for future economic planning. Although the volatility of profits has increased and earnings persistence has decreased, the nature of revenues, expenses, and earnings have not really changed. This is because changes in accounting, specifically balance sheet changes, has increased the number of unusual items included on income statements that may confuse users of financial statements examining the bottom line. In addition, the balance sheet approach is not as useful in practice as it may seem. Due to the subjectivity in fair value measurement, there is increased ambiguity in accounting that could decrease trust in accounting and provide more opportunities for financial manipulation.

Dichev and Penman offer suggestions for a more appropriate Conceptual Framework in modern accounting. The importance of distinguishing operating activities, where resources are primarily used to support business workings, from financing activities, which revolve around cash and cash-equivalent items, is stressed in addition to differentiating assets from these activities. In addition, it is suggested that there should be different bottom lines for different business activities in a firm, such as operating, investing, and more. Dichev and Penman believe there should be more emphasis on clearly defining and using the expense matching principle and revenue recognition principle to better help managers make decisions in planning for operations and profits.

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

Throughout my studies in accounting, the balance sheet approach has been the primary focus of the concepts I have learned, so I had never considered that there was a different approach to accounting. Assets and liabilities have been presented as more permanent components of businesses and were taught in great detail while revenues and expenses were temporary items that contributed to the value of assets and liabilities. However, Dichev and Penman's article made interesting points about why income statement items should be the foundation for value in accounting that caused me to reassess if assets and liabilities really are the best way to define and measure other elements of accounting.

Under the balance sheet view, I had viewed revenues and expenses only as temporary accounts that contributed to the balance sheet as a whole when they were closed out to retained earnings at the end of the year. Profits simply served as a foundation for determining the value of net assets to the firm. However, this essay provided an essentially opposite perspective, presenting assets as the temporary financial items that contribute to the creation of the persisting revenues and expenses. Since assets have been presented as current and long-term items that would maintain a mostly consistent presence on the balance sheet, I had viewed many of them more as fixtures for a firm rather than resources. One of the points in the article that I found most interesting was Dichev and Penman's description of viewing assets as expenses that have not yet been used in business operations. Although I viewed cash, inventory, supplies, and similar accounts as items expended in business operations, other assets seemed more permanent over the business cycle of firms. With the income statement perspective in mind though, I have now thought about depreciation expense in particular in a different light because it is the expense of the usage of assets, similar to inventory and supplies. This treatment of assets contributes to the generation of revenues, and the expense is matched to the revenues, so the income statement view is actually reasonable. These assets are not as enduring as the balance sheet approach may make them out to be, so I have found it important to reassess the relationship between assets, liabilities, and earnings and their significance to companies overall.

Furthermore, I agree with the authors that the income statement information is more helpful to most users of financial statements; the general public and many shareholders of companies may only have basic knowledge of accounting and look to the income statement for quick and simple understanding of the state of the business. It can be difficult to interpret how the change of values in many assets and liabilities are contributing to the overall condition of a firm. In accounting principles, the quality of understandability in accounting information encourages the preparers of financial information to present it clearly and succinctly for decision-makers. However, by placing the focus on the balance sheet for information, it may detract from decision-makers' comprehension of financial reports, since they place importance on profits.

I did not realize how greatly the accounting of the balance sheet could influence the presentation of the income statement. When Dichev and Penman discussed the effect of infrequent transactions from adjustments of asset values that would not otherwise reflect the income from operations, the growing inconsistency of earnings from year to year made more sense. Although the income statement is positioned to separate income from continuing operations from overall net income, the effect of extraordinary items on net income may mislead decision-makers and negatively affect stock market evaluation. Some non-recurring revenues, expenses, gains, and losses are necessary to include to reflect the activities of the business, but those based on uncertain valuations may not be beneficial to display to users of financial statements.

In class, it has been discussed how fair value is becoming increasingly more important in accounting when the fair value is available and appropriate because it provides the most faithful representation in valuation of balance sheet items. However, this essay elaborated on the weaknesses of the subjectivity of the fair value approach, even pointing out how subjectivity in accounting led to the Enron Scandal. Because accounting is generally susceptible to estimates, I had accepted that fair value was a perfectly appropriate way to value assets and liabilities. I still believe that the fair value method can be a beneficial concept to be used in accounting, but considering the weaknesses noted by Dichev and Penman, there may need to be more guidelines and regulations placed on fair value to ensure that businesses are not manipulating financial reports or taking advantage of the subjectivity of fair value.

After reading the article, I agree that there should be a combination of the income statement and balance sheet approach, or even that businesses should have the option to choose between the two approaches based on the nature of their business. Although it may create challenges in consistency and comparability between the financial reports of different businesses, it could prove to be more practical for companies of different business sectors to use different approaches that best reflect their primary operations. FASB could recommend that businesses of certain natures use a specific approach over the other to enhance comparability between businesses of similar natures.

How will you use this information in your future career?

Because FASB is the governing body for accounting principles and regulations, and they prefer usage of the balance sheet method, the income statement approach has limited application in the current world of accounting. Especially as a new accountant in the workplace, it is important to follow FASB guidance and other regulations in order to maintain integrity while continuing to learn how work is to be done. Nevertheless, the perspectives offered in “On the Balance Sheet-Based Model of Financial Reporting” can still be useful in situations that I may face in a career in accounting.

From now on, I will view revenues and expenses as more persistent rather than simply temporary accounts that are just buried into the balance sheet. Because operating activities are more consistent than other activities in the business, I now realize the importance of viewing revenues and expenses as a display of how well operating activities are being conducted and how they may be more indicative of these activities than the values of assets and liabilities. In addition, the significance of the revenue recognition and matching principles will be helpful in auditing because I will need to determine if businesses are appropriately matching and allocating their expenses to the correct revenues from operations. Businesses may manipulate expenses to charge them earlier than appropriate or use them to their advantage at a later time, so it is important to confirm that they are matched to the proper event.

In making estimates for items, I think more carefully about how the estimates are made and if they are being made fairly and accurately. For example, in determining the fair value of a company’s building to include in financial statements, it is important to assess if the valuation is accurately reflecting the market value or if the value chosen has been manipulated to the advantage of the firm. Although fair value can be beneficial in best reflecting the financial condition of the firm, there must be careful calculation involved to ensure that the assessment of fair value is unbiased. In addition, this carefulness can be applied in determining the salvage value of a building or how intangible assets should be amortized. In choosing the best depreciation method for a certain piece of equipment, I will be more attentive to how the annual depreciation expense reflects the use of the asset. My perspective of depreciation and amortization has also changed to view these noncurrent assets as resources that contribute to specific projects and earnings. It will be valuable to be more conservative in estimates because their subjective nature is more at-risk to manipulation.

However, there are possibilities that someday I could potentially be a member of influential groups that have impact on the principles of accounting, or even a member of FASB itself, and this information could aid me in making decisions regarding generally accepted accounting principles. If I were a member of FASB, I would be interested in suggesting that the Conceptual Framework be amended to incorporate pieces of the income statement approach. Due to the primary goal of most businesses of generating profits and the importance of income statement to stockholders and other decision-makers, the income statement view may be better than the balance sheet approach for the future of financial reporting as it was useful for businesses throughout history. Since the balance sheet method has been integrated into FASB's Conceptual Framework, it may be best to integrate parts of the income statement method rather than change the entire framework, but it would be advantageous to increase the relevance of revenues, expenses, and earnings in financial reporting.

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CASE 12

Non-GAAP Earnings – Google Inc.

Introduction

This case examines the treatment of non-GAAP earnings and their significance in accounting within the context of Google Inc. Non-GAAP earnings are descriptions of earnings that are not reported on company financial statements, including earnings before interest, taxes, depreciation, and amortization, known as EBITDA. This case will discuss how non-GAAP earnings are different from GAAP income that is reported on financial statements. Companies will report on non-GAAP earnings measures in press releases and other reports. Reports other than financial statements that may include non-GAAP earnings may have effects on the actions of the stock market. There are also other factors that influence the reactions of the stock market. Some of the factors that affect the fluctuation of Google's stock price will be examined, and the stock price will also be compared to the NASDAQ index.

Through this case, I learned about the effects of non-GAAP earnings from an accounting standpoint rather than in the context of finance. Although EBITDA had been discussed in other classes, the differences in use between non-GAAP earnings, such as EBITDA, and financial statement information had not been clarified. This case allowed me to learn about the specific components that create the difference between non-GAAP earnings and financial statement income. Although EBITDA and other classifications of earnings may not follow GAAP, an understanding of these types of earnings is useful to a career in accounting. Accountants should consider non-financial statement information because press releases and other reports can be useful in the auditing process. Non-GAAP earnings may also be more relevant to investors, which FASB is considering, and this may shape the future for accounting.

I. **Read the excerpts of the press release, "Google Announces Fourth Quarter and Fiscal Year 2013 Results."**

- **Consider the table that reconciles GAAP measures to the non-GAAP measures. What explains the difference between GAAP net income and the non-GAAP equivalent? Do you agree with each of Google's adjustments in computing non-GAAP earnings? Why or why not?**

The GAAP net income for 2013 was $3,376 million while the non-GAAP equivalent was $4,096 million. The differences between these two measurements are due to stock-based compensation expenses added back to GAAP net income and restructuring charges subtracted from net income, both net of tax, in addition to net loss from discontinued operations added to net income to calculate the non-GAAP income.

I agree with Google's adjustment for the net loss from discontinued operations and restructuring and related charges. These items are both unusual charges that are not indicative of Google's periodic performance and may only occur infrequently in future periods. The exclusion of these charges may be more relevant to decision-makers because they do not reflect ongoing earnings performance. However, stock-based compensation expense appears to be a recurring expense for Google, expensed at $700 million and $902 million, in the fourth quarters of 2012 and 2013, respectively, and may not be an appropriate adjustment for non-GAAP earnings. In the press release, Google claims that it is adjusted as a non-cash charge that does not reflect the actual operations of Google, but since the expense appears to happen periodically, it may be useful to include in the presentation of non-GAAP earnings for decision-makers since they may be interested in other large expenses that Google has each year.

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

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

In Google's fiscal 2013 year, the company's earnings performance increased from the previous year. At the end of the fourth quarter ending December 31, 2012, the non-GAAP earnings were $3,568 million compared to the $4,096 million of non-GAAP earnings for the fourth quarter ending December 31, 2013. Meanwhile, the net income increased $10,737 million at the end of 2012 to $12,920 million at the end of 2013. There is an overall increase in the stock price of Google over fiscal 2013, starting at $707 in January 2013 and rising to approximately $1,200 by the end of February 2014. The rise of the stock price followed the overall increase in earnings, both GAAP and non-GAAP measures. The stock price change differed though for each release of quarter earnings. After the first and second quarters, there were no significant increases or decreases in the stock price after press releases. However, when third quarter earnings were released, the stock price jumped from about $900 to over $1,000. The fourth quarter earnings also showed a spike in the stock price, increasing from about $1,100 to nearly $1,200.

- **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).**

Google's stock price performance was throughout 2013 was mostly higher than the performance on the NASDAQ index. At the beginning of the year, the Google price performance rose slightly above the performance of the NASDAQ exchange until late

January when the performance dramatically dipped. Google's stock price performance increased again in February and remained above the NASDAQ exchange performance until they were about even in October. At the end of October, the stock price performance significantly increased and continued to have performance of approximately twenty percent to thirty percent higher than that of the NASDAQ index until the end of the year.

- **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"?**

The market perceived the earnings in the January 30, 2014 press release as good news because the stock price peaked when Quarter 4 earnings were released. Although the stock price was approximately $1,100 before the earnings were released, it increased to near $1,200 after the press release was made.

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

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

The analysts predicted that Google would have revenue of $16.8 billion while the actual revenue for the fourth quarter was reported as $16.9 billion. Since the actual revenue was greater than the forecasted revenue, the positive stock market reaction was consistent with this report because Google shareholders would be pleased that Google had better financial results than what was expected.

- **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 factors discussed in the article that may have contributed to the positive reaction of the market may have been the increase in ad clicks and the success of app sales through the Google Play store both of which increased overall revenue. In addition, the sale of Motorola to Lenovo could have pleased the market because it ended the periodic losses from Motorola on Google's financial statements and improved the bottom line for the 2013 fiscal year. One factor that might have created concerns among investors was that the actual earnings of $12.01 per share for non-GAAP earnings rather than analysts' predictions of $12.20 per share. In addition, the individual revenue of each ad click declined due to the rising popularity of phones, as phone clicks generate less revenue than computer clicks due to the smaller screen size; this may result in decreased revenues in time which could worry investors.