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An Analysis of Accounting Principles As Seen Through Case Studies

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AN ANALYSIS OF ACCOUNTING PRINCIPLES AS SEEN THROUGH CASE STUDIES

By
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ABSTRACT

BROOKE BAUMGARDNER: An Analysis of Accounting Principles as Seen Through Case Studies
(Under the direction of Dr. Victoria Dickinson)

This document represents the work done over the course of a year under the direction of Dr. Victoria Dickinson in Professional Research and Development Thesis Program at the University of Mississippi. The purpose of this program is to allow students who plan to work in a professional field to complete a thesis which is more applicable to their future endeavors than a traditional thesis. The twelve case studies that are completed and represented within this thesis were chosen to cover a variety of accounting topics that are similar to what students entering this field will see on a day-to-day basis. By completing these cases, students are able to see how the principles and theories that are taught in lecture have suitable applications to real world situations. Additionally, the completion of a number of these case studies required a group effort, a condition that allowed students to work on their communication skills and gain additional practice in delegation – skills that are essential to be successful in the professional accounting sphere.

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Case Study One

Data Analytics - Tableau

1. **Introduction**

    a. The purpose of this case was to introduce students to the up-and-coming and current technology being used in public accounting. This case also allowed students to explore how these technologies could affect the work that they will be doing once they begin working in the areas of audit and tax and how they could further improve the profession in the future. The particular data processing software researched by my group was Tableau, a program that allows users to create visual representations of large amounts of data for more efficient data analysis.

       From this activity, I have gained an insight into the convergence of technology and audit and tax, a pairing that I was not extremely familiar with. With this new knowledge, I feel that I am more prepared to exceed the expectations regarding data processing software that my future employer may have of me compared to my peers who have not been introduced to this topic.

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

    a. In the past, there have been various issues in the business world that stem from an inability to quickly analyze vast amounts of data. One solution to this problem is Tableau. This tool, Tableau, allows users to turn large swaths of data into simple to understand visuals. Separating it from similar data processing systems is its incredibly user-friendly interface, which allows those with all levels of technological skill to obtain useful information from the program. A visual representation of data would greatly increase the data transparency across industries, as the data can be compared to similar data within the industry. In day-to-day business operations, this transparency would expedite multiple business processes as associates would no longer have to dig through data in order to make a well-educated decision.

3. **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.**

   a. **Audit**

   1. One feature of the Tableau program is the ability to input data from accounts such as sales and returns to analyze trends. During an audit, this trend analysis would make detecting an unusual trend or finding a numerical outlier very simple. The auditor could then pull that particular piece of data and attempt to deduce what the issue may be.
   2. Also using the trend analysis feature, it would be possible for an auditor to compare the company's growth rate to average growth rates in the industry. If the company is doing well above the norm or are on a trend curve that does not reflect the current state of the economy, it may give the auditor a reason to look further into their revenue and expense accounts.

3. A few stand-out features of Tableau are its ability to allow users to select only certain data series to display at one time and allowing multiple users to access the same file simultaneously. This would expedite the auditing process as many associates could be reviewing several accounts at one time. Also, this would allow time for reports to be checked by multiple people.

b. **Tax**

1. The Tableau program also contains various forecasting features. By using this, companies would be able to input their data, along with tax codes from multiple nations, to see where they would have the lowest tax liabilities when considering expansion into international markets.
2. Also using the forecasting feature, it would be possible to determine a company's future tax liabilities if they continue to grow at a constant rate. However, it would also be possible to predict future tax liabilities if the company performed better or worse than expected. This would allow companies to at least be aware of what taxes they may be responsible for in the future.
3. The visualization abilities of Tableau would allow companies to see the areas of operation where they are most heavily taxed. By doing this, companies would be able to decide if operation should continue or cease in these highly taxed areas depending on their revenues and expenses, among other factors.

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

    a. Dear Sir or Madame,

        After reviewing the data processing program Tableau, I believe an investment in this technology would be beneficial for the team. The data visualization this program provides would cut down on the amount of time it takes to process accounts during the auditing process. It also allows for future projections, a feature that would aid associates while consulting with companies regarding tax liabilities.

        Additionally, the visual aspects of this program would allow those who are not traditionally trained in data analytics to easily interpret said data. These individuals could then also offer valuable input on the account and how it should be handled.

        The time saved by no longer having to manually analyze accounts would allow associates to handle multiple clients at once, as well as reducing the number of hours they have to spend on individual clients. This time could then be used to process more clients or for staff development to ensure that the associates are up to date on training for the Tableau program.

I truly believe that this technology would benefit the firm and I thank you for taking the time to consider investing in this software. I look forward to hearing your decision.

Best,

Brooke Baumgardner

Case Study Two

Rocky Mountain Chocolate Factory, Inc. –

Preparing Financial Statements

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

Figure 2-1: Summary of Case/Learning Moments and Requirement A

Summary of Case/Learning Moments
This case concerned the financial statements and corresponding transactions incurred by Rocky Mountain Chocolate Factory from February 2008 - February 2010. After analyzing and organizing the data, it was necessary to create several financial statements to reflect this period.
Through creating and analyzing multiple financial statements and sets of data in this case, I was able to gain a deeper understanding of the connections between various financial statements and how information flows through each. Additionally, I learned how to create various financial statements in Excel, a task that I had never done before. I belive that this extra experience with Excel will benefit my future career as it is an extremely common tool used by
Prior to examining the company's actual balance sheet, read the description of Rocky Mountain Chocolate Factory, above. What accounts do you expect to see on the balance sheet? Which accounts constitute the major assets? Which accounts constitute the major liabilities?
Some accounts that I would expect to see on the balance sheet are possibly different inventory accounts concerning manufacturing and retailing, multiple accounts receivable, multiple accounts payable, and separate equity accounts for the different regions of operation. I would think that the major assets would consist of different production facilities and the equipment inside, as well as inventories across multiple regions. Major liabilities may consist of long term debt for the factories and equipment, as well as accounts payable to different suppliers.

b -g, i . All transactions for requirements b -g and requirement i are included in the diagrams provided in this and the next page.

Figure 2-2: Rocky Mountain Chocolate Factory General Journal

		Beginning Balance (February 28, 2009)	1. Purchase Inventory	2. Incur Factory Wages	3. Sell Inventory for Cash and On Account	4. Pay for Inventory	5. Collect Receivables	6. Incur SG&A (Cash and Payable)	7. Pay Wages	8. Receive Franchise Fee	9. Purchase PPE	10. Dividends Declared and Paid	11. All Other Transactions	Unadjusted Trial Balance
Debit	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 Recievable	$ 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
	Other	$ 91,057.00											$ (3,007.00)	$ 88,050.00
Credit	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)				$ -	$ -
	Othe Accrued Expense	$ 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
	Franchise and Royalty Fees	$ -											$ 5,492,531.00	$ 5,492,531.00
Debit	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 and Marketing	$ -						$ 1,505,431.00					$ -	$ 1,505,431.00
	General and Administrative	$ -						$ 2,044,569.00					$ (261,622.00)	$ 1,782,947.00
	Retail Operating	$ -						$ 1,750,000.00					$ -	$ 1,750,000.00
	Depreciation and Amortization	$ -											$ -	$ -
	Interest Income	$ -											$ (27,210.00)	$ (27,210.00)
	Income Tax Expense	$ -											$ 2,090,468.00	$ 2,090,468.00
	TOTAL ASSETS	$ 16,841,052.00												$ 19,835,330.00
	TOTAL LIABILITIES AND EQUITY	$ 16,841,052.00												$ 14,693,681.00
	DISCREPANCY	$ -												$ 5,141,649.00

Figure 2-2: Rocky Mountain Chocolate Factory General Journal

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
$ 3,743,092.00					$ 3,743,092.00	$ -	$ 3,743,092.00	$ 3,743,092.00
$ 4,427,526.00					$ 4,427,526.00	$ -	$ 4,427,526.00	$ 4,427,526.00
$ 91,059.00					$ 91,059.00	$ -	$ 91,059.00	$ 91,059.00
$ 3,498,283.00	$ (216,836.00)				$ 3,281,447.00	$ -	$ 3,281,447.00	$ 3,281,447.00
$ 461,249.00					$ 461,249.00	$ -	$ 461,249.00	$ 461,249.00
$ 220,163.00					$ 220,163.00	$ -	$ 220,163.00	$ 220,163.00
$ 5,885,289.00		$ (698,580.00)			$ 5,186,709.00	$ -	$ 5,186,709.00	$ 5,186,709.00
$ 263,650.00					$ 263,650.00	$ -	$ 263,650.00	$ 263,650.00
$ 1,046,944.00					$ 1,046,944.00	$ -	$ 1,046,944.00	$ 1,046,944.00
$ 110,025.00					$ 110,025.00	$ -	$ 110,025.00	$ 110,025.00
$ 88,050.00					$ 88,050.00	$ -	$ 88,050.00	$ 88,050.00
$ 877,832.00					$ 877,832.00	$ -	$ 877,832.00	$ 877,832.00
$ -			$ 646,156.00		$ 646,156.00	$ -	$ 646,156.00	$ 646,156.00
$ 946,528.00					$ 946,528.00	$ -	$ 946,528.00	$ 946,528.00
$ 602,694.00					$ 602,694.00	$ -	$ 602,694.00	$ 602,694.00
$ 220,938.00					$ 220,938.00	$ -	$ 220,938.00	$ 220,938.00
$ 894,429.00					$ 894,429.00	$ -	$ 894,429.00	$ 894,429.00
$ 180,808.00					$ 180,808.00	$ -	$ 180,808.00	$ 180,808.00
$ 7,626,602.00					$ 7,626,602.00	$ -	$ 7,626,602.00	$ 7,626,602.00
$ 3,343,850.00					$ 3,343,850.00	$ 3,580,077.00	$ 6,923,927.00	$ 6,923,927.00
$ 22,944,017.00					$ 22,944,017.00	$ (22,944,017.00)	$ -	$ -
$ 5,492,531.00					$ 5,492,531.00	$ (5,492,531.00)	$ -	$ -
$ 14,693,786.00	$ 216,836.00				$ 14,910,622.00	$ (14,910,622.00)	$ -	$ -
$ 1,499,477.00					$ 1,499,477.00	$ (1,499,477.00)	$ -	$ -
$ 1,505,431.00					$ 1,505,431.00	$ (1,505,431.00)	$ -	$ -
$ 1,782,947.00			$ 639,200.00		$ 2,422,147.00	$ (2,422,147.00)	$ -	$ -
$ 1,750,000.00			$ 6,956.00		$ 1,756,956.00	$ (1,756,956.00)	$ -	$ -
$ -		$ 698,580.00			$ 698,580.00	$ (698,580.00)	$ -	$ -
$ (27,210.00)					$ (27,210.00)	$ 27,210.00	$ -	$ -
$ 2,090,468.00					$ 2,090,468.00	$ (2,090,468.00)	$ -	$ -
$ 19,835,330.00					$ 18,919,914.00			$ 18,919,914.00
$ 14,693,681.00					$ 15,339,837.00			$ 18,919,914.00
$ 5,141,649.00					$ 3,580,077.00			$ -

h. Construct an income statement for the year ended February 28, 2010. Use the headings from your spreadsheet rows as the account titles.

Figure 2-3: Rocky Mountain Chocolate Factory Income Statement

Rocky Mountain Chocolate Factory			
Income Statement			
For 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
Cost and Expenses			
Cost of Sales	$ 14,910,622.00		
Franchise Costs	$ 1,499,477.00		
Sales and Marketing Expenses	$ 1,505,431.00		
General and Administrative Expenses	$ 2,422,147.00		
Retail Operating Expense	$ 1,756,956.00		
Depreciation and amortization	$ 698,580.00		
Total Costs and Expenses			$ 22,793,213.00
Operating Income			$ 5,643,335.00
Other Income/Expense			
Interest Income			$ 27,210.00
Interest Expense			$ -
Other, Net			$ 27,210.00
Income Before Income Taxes			$ 5,670,545.00
Income Tax Expense			$ 2,090,468.00
Net Income			$ 3,580,077.00
Earnings Per Share	**$0.60 per Common Share Outstanding**		

j. Prepare the February 28, 2010, balance sheet. Use the headings from your spreadsheet rows as the account titles.

Figure 2-4: Rocky Mountain Chocolate Factory Balance Sheet

Rocky Mountain Chococlate Company		
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	
Deffered 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**	
Liabilites and Stockholders' Equity		
Current Liabilities		
Accounts payable		$ 877,832.00
Accrued salaries and wages		$ 646,156.00
Other Accrued expenses		$ 946,528.00
Dividends Payable		$ 602,694.00
Deferred Income		$ 220,938.00
Total current liabilities		$ 3,294,148.00
Deferred Income Taxes		$ 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**

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

Figure 2-5: Rocky Mountain Chocolate Factory Cash Flow Identification

Transaction Cash Flow Indentification	
Transaction	**Cash Flow Section**
1	Operating
2	Operating
3	Operating
4	Operating
5	Operating
6	Operating
7	Operating
8	Operating
9	Investing
10	Financing
12	Operating
13	Operating
14	Operating
15	No Transaction

Case Study Three

Debate Concerning Internship and Recruiting

Ethics

1. Introduction

This case was very interesting as it was mainly based on the varying opinions of my classmates, myself, and Dr. Dickinson. Central topics in this case included various situations regarding internships and how they function for students and the Patterson School of Accountancy and plans for life after the undergraduate program, including graduate school, law school, and entering the workforce.

I believe that this case was beneficial for my classmates and I as it allowed us to voice our individual opinions in a way that allowed us to truly take into account all that was being said and adapt our personal opinions if we felt moved to do so. Also, the input from Dr. Dickinson, as a member of the faculty who has an abundance of experience with accounting internship placement and the aftereffects, was personally extremely helpful as she was able to answer many of my questions concerning this topic.

2. Situations Debated

a. The first situation discussed revolved around an accounting student pursuing an accounting internship while knowing they ultimately wanted to attend law school. This posed the question of is it okay to accept an accounting internship while fully knowing that you do not plan to continue your employment with that firm after the internship has concluded?

Personally, I believe that this would be an unwise decision to make as a student as it makes it appear that the School of Accountancy is unable to provide firms with students who will ultimately turn a profit.

Additionally, one large stipulation of the student's plan to go to law school involved the fact that one of their relatives made a very high salary practicing tax law at a law firm in New York City. I think that this fact can be almost completely discounted as salaries are often related to the cost of living in the area in which you are working. In New York City, where the cost of living is ridiculously high, it makes sense that the relative would be making a very large salary compared to someone doing the same work in the Southeast where the cost of living is much lower.

b. The second situation featured multiple students discussing their uncertainty about future plans, whether that be working in a public accounting firm or entering another sector of the business world, such as Investment Banking and Finance. The question posed in this discussion centered around the idea that it is okay to use an accounting degree and internship as a sort of spring board into other areas of business or to help you decide where you see your future career going.

Personally, I completely agree with the position that these students took. As accounting is "the language of business", an accounting degree can be extremely versatile for all areas of business. Also, as there is not normally a direct route from undergrad to something more specialized like Investment Banking and Finance, accounting provides individuals a place to hone their business skills and discern what avenues they might want to explore in the future based on their interests.

The last scenario involved a student communicating with Dr. Dickinson their desire to transfer an offer of employment within a firm from the office that they completed their internship at to one closer to home. The question that stemmed from this dilemma was is it okay to request to transfer offices after you have only completed a ten-week internship there?

As someone who has moved many times, it is sometimes easy to tell whether you are going to enjoy living in a certain place a relatively short time into your stay there, but I have also had experiences in which it took a little bit of time to acclimate to the new environment and become comfortable there. I think that one main factor of accounting internships that scare students is the process of picking what city you want to intern in, as this is most likely where you will be (or at least should be) beginning your career and spending around the first three years of your professional life. This can be a bit overwhelming for a twenty-year-old college student. This may lead to the low rates at which offices are having of students returning to work full time after internships as some students quickly decide on a city based on how "cool" they think it will be for the ten weeks and now how well they will like it for three years.

While I do think that it would be okay for this student to request a transfer, I would recommend that they be extremely transparent with the firm as to why they would like the transfer. Also, they should not be surprised if the transfer is not immediately approved, as, especially in Dallas, there are many other schools besides Ole Miss that feed into the firms.

Overall, I believe that the key for all of these situations is being transparent with the firms about what your future plans and ambitions are during recruiting so that you are both on the same page throughout the entire process. It is also very important for current accounting students to remember that the fantastic relationships that the Patterson School of Accountancy enjoys with multiple public accounting firms have developed over many years through the hard work of the faculty and past students. Thus, it is the current students' responsibility to ensure that these relationships remain in good shape for future generations of Patterson School Students.

Case Study Four

Generic Bank: Accounting for Debt Securities

Sales and Impairments

1. Introduction

This case, presented by Dr. Brett Cantrell, focused on how banks determine if impairments will be applied to their various investments in debt securities if they are sold. In order to correctly complete this case, it was necessary to research the effects of these impairments and how they are determined in the FASB codifications. This case also required the student to look into topics that had been unexplored in class up to this point, such as the process to sell a debt security, the requirements for a debt security to receive an impairment, and what debt securities and impairments are. It also introduced students to some of the investing activities that banks engage in besides providing commercial and consumer loans.

I personally found this research to be interesting as I had never had the opportunity to actually look into the codifications that are discussed so frequently in class. I believe that this was a beneficial case to complete as a class because I, as well as my peers, have had very little exposure to things concerning impairments on debt securities. Before this case, I had heard of debt securities but I was completely unaware of the technicalities that have to be met in order to trade these kinds of investments. Yet, due to the fact that the recession of 2008 and 2009 was due to defaulting on these securities, I am not surprised that the code has been updated to clarify and specify the regulations concerning these debts.

Requirements

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

   As specified in the ASC 326-30, the first step in determining if an impairment should be placed on a security is deciding whether the decrease in value comes from a fear of not being able to have the debt payed off, or if it is due to outside market forces. If it is decided that the change has to do with market conditions the next explored area will be the security's market price compared to its amortized price. Also taken into consideration is if the bank plans to continue to hold ownership of these securities until the market price more closely aligns with the amortized price.

   When looking at the securities that Generic Bank wishes to sell, they all fulfill the requirement of having a loss stemming from a market cycle. The bank is also planning on selling all the aforementioned securities, so the stipulation concerning holding securities until the market rebounds can be disregarded. However, when more closely examined, there are multiple securities whose market value is higher than their amortized value. This includes the securities with the CUSIP numbers 067 and 096, which have amortized values $16,338 and $7,867 respectively over market value.

2. **Assume that Generic Bank does sell the aforementioned securities shortly after year end in 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?**

In order to have a recognized impairment loss, the bank would have to actually sell additional securities as impairments are not recognized on securities that the establishment shows intent to hold until market stabilization occurs. However, if the bank decided to sell other securities that it currently holds, there would be multiple that would receive impairments.

In the future, the bank may face more impairment issues due to the fact that they did sell seven securities at one time. This makes it appear that the bank is not willing to hold onto securities until the market is able to recover and it quick to dump anything that is causing a loss. Nonetheless, this may also be offset by the fact that the bank is in a very strong position financially.

In order to calculate what this impairment would be, the difference between the market value and amortized value is taken and is applied as a credit towards the amortized balance. This allows the security to be written off when it is sold at market value.

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

On the surface, it may seem that different individuals involved in this issue would have drastically differing views on the topic based on their specific motives. I disagree with this notion. I believe that if these individuals are truly following the FASB codification, which they should be as it covers both audit and internal regulation, they would perhaps have a small difference of opinion on some nuisances of the deal, but overall, they should agree.

The main factors that both of these individuals should be taking into account should be how these impairments are decided according to the FASB codification. If these regulations are followed, the difference in opinion come down to what areas of the business they are interested in based on what the person's position in relation to the company is.

As an auditor, Heather Herring may focus more on the timing of when these debt securities are being sold, as this may directly relate to the overall financial health of the bank and may reflect how other areas of the business are preforming. If you assume the role of the bank regulator, you may be more concerned with how selling these specific securities will affect the value of the rest of the bank's portfolio and if it would be more profitable in the long run to hold onto the securities until market conditions improve.

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

   If the securities sold had been collectively in a net gain position, it would be necessary to look at each security on an individual basis. If one specific security had a higher market value than amortized value, then there would be no reason to place an impairment on that security. Oppositely, if there was a security that had a lower amortized value than market value, it would make sense to place an impairment on the security. Another aspect to consider is that if they did not cause the bank to take a loss overall, then there would be less of a reason to place a collective impairment on the securities.

   If all of the securities were sold in a gain position, there would be no reason to place impairments on any of them as their sale is adding value to the company and is not negatively affecting its financial position.

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

   As the bank is in the process of restructuring to improve its financial position, there may be multiple impairments placed on its securities. If the market value and amortized values are the same as they were when the bank was in better standing, there would be reasoning for impairments to be placed on these debts. Also, even though the securities were not sold in the year 20x3, there was intent to sell in the year 20x3.

Alternately, the fact that the bank is only selling its riskiest assets reflects positively on the status of the rest of their securities, as they do not seem to have any plans to sell anything that they consider to be a safe investment. I also think that this reflects positively overall on the bank as they have a plan to improve their economic position. Similar to the situation in requirement two, I do not believe that there would currently be any additional impairments on securities not being sold as they do not meet the requirement of intent to sell.

Case Study Five

City Selection Case

1. Introduction

The purpose of this case was to explore various aspects of two cities that we were considering starting our careers in upon graduation. Many different characteristics of the cities were discussed, including the topography, living costs, and plans to travel back home. At the conclusion of the case, students were asked to choose which city might be a better fit for them and explain the rationale behind their decision.

Overall, this case was very helpful in helping students who are trying to decide what city they may want to live in post-graduation as it brings up many issues that are often not thought about before making a move, such as where to buy groceries and how laundry is going to be done. Personally, I have had a very strong pull to Houston for my entire college career, so this was a fun case to be able to learn a little more about the city that I would love to end up in.

2. City #1 – Houston, TX

The first city that I am interested in living in upon graduation is Houston, TX. The current population of the city is 2.313 million. As I have lived in small towns for the majority of my life, I think that living in a large city would be a nice change. Houston's climate is technically classified as humid subtropical, with highs in the 100's during the height of the summer, and lows in the 40's in the winter. However, one weather problem that Houston is very susceptible to is flooding, as it is low-lying and close to the Gulf of Mexico. As this is the climate of my hometown, I am very comfortable with this.

As most of the city was built on a bayou, the overall topography is relatively flat. One feature that distinguishes Houston from many other cities in Texas is its extensive highway system downtown that weaves in and out of the existing buildings. There are also various parks throughout the city and the beach is only an hour away if you need a break from the hustle and bustle.

One advantage of living in Texas in general is the fact that there are no local or state income taxes. However, they more than make up for it with higher property tax rates. Applying this, I would have to pay around $10,000 a year in federal income taxes. Property tax wise, it depends on the specific area you live in, but the median rate is around 2.3 percent. As I plan to live at home for my first year, property tax would not directly affect me, but as soon as I began to pay rent to live closer to downtown, this tax would be built into rent payments.

There are many different options for public transportation downtown, including both a METRORail and a MetroBus system. Taxis also have a $6 flat rate for any trip in the downtown area. However, the majority of young professionals working and living downtown that I have spoken with say that it is very common to just walk to work.

The majority of companies based in Houston are in the Energy sector, namely oil and gas. Personally, I do not know much about the oil and gas industry, but I would be very interested to learn about the structure and procedures of the companies that provide the country with energy.

As Houston is one of the largest cities in the country, it has a very large medical presence. In fact, the Texas Medical Center, the largest medical center in the world, is just 10 minutes from downtown. Additionally, there are several MD Anderson centers throughout the city. I would feel very comfortable being able to access any kind of medical care I might need in Houston.

As there is a large population in Houston, there is somewhat of a high number of crimes. However, the majority of crimes are property crimes – mostly theft from vehicles – and not violent crimes. The violent crimes seem to be concentrated in the South Union area, so I would be sure to avoid that area. The high numbers do not make me quite as nervous once the population number is taken into account.

For the first year of my career, as my family is only 35 minutes from downtown, I plan to live at home to save up money for rent and future expenses, such as a car. Once I move downtown, I plan to live in the Midtown area, which is very popular with young professionals. After looking at apartments online, I believe that after 2 years I would have an accumulated rent cost of $21,948. This is based on a unit that is 1,293 square feet, has 2 bedrooms, 2 bathrooms, in-unit laundry, and an option for on-site parking for an additional $40 a month. I would have a roommate in order to lower costs.

The typical mode of commuting for professionals living and working downtown is walking to work or using the METRORail. Depending on the exact location of where I live, I can see myself using either one of these options. Uber and other ridesharing apps are also very popular downtown. I believe that my commute time, even on busy days, would be no more than 30 minutes as the midtown area is very close to where multiple firm's offices are downtown.

There are multiple grocery stores around the midtown area, including a Randall's, an H-E-B, and a Whole Foods. I am honestly surprised that there were so many food shopping options in this area. Laundry wise, most apartment units in the midtown area have in-unit laundry, so that would not be a problem. Once I have moved to Houston, I would like to get involved in a church, although I am not opposed to driving back to the one I currently attend at home on Sundays. I would also like to get involved with the Houston Food Bank and the Houston Humane Society. I believe that volunteering in your community not only helps the community, but gives you an internal feeling of accomplishment.

While living in Houston, there are many sporting events that I would love to attend, including Astros, Texans, and Rockets games. Additionally, there are multiple concert venues in Houston including the House of Blues and the Toyota Center that would allow me to attend many performances. Another activity that I would enjoy doing in Houston would be going to the Houston Ballet. I would love to live in a city that allows for so many different entertainment options, as the town I currently live in is lacking in this area.

My hometown is only 35 minutes from downtown so it would be very easy to visit my family. I would drive back home whenever I wanted to visit and as my car gets very good gas mileage, I don't believe it would cost more than $35 in gas to go back home.

MONTHLY OPERATING BUDGET

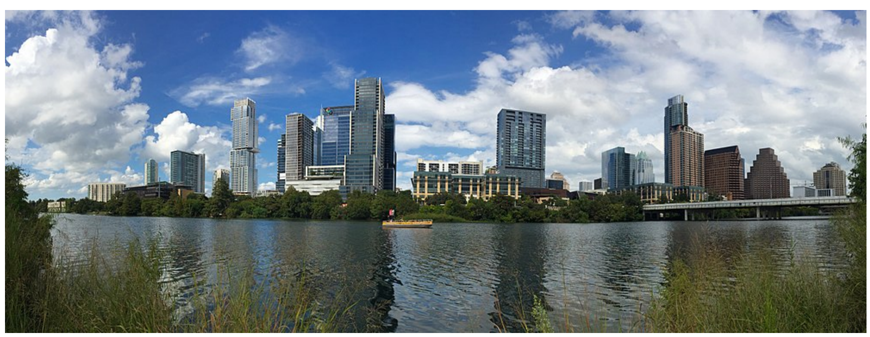
Figure 5-1: Monthly Operating Budget - Houston

MONTHLY INCOME – TAXES AND HEALTCARE	**$3,875**
RENT	**$914.00**
UTILITIES	**$78.54 (split 50/50 with roommate)**
CAR INSURANCE + GAS	**$200**
GROCERIES	**$200**
EATING OUT	**$300**
TELEPHONE / DATA	**$250**
ENTERTAINMENT	**$200**
SAVINGS	**$1,732**

3. **City #2 – Austin, TX**

Another city that I would be interested in living in upon graduation would be Austin, TX. Austin has a population of around 900,00 – this is smaller than Houston but still much larger than my hometown. I think that living in a bigger city, in particular the capital of Texas, would be a very cool experience to have.

As it is further north than Houston, it is much less humid, but still has long, hot summers, mild winters, and transitional temperatures in between. Austin is located on the edge the Texas Hill Country, with the downtown area being very flat. The city has a central park called Zilker Park and there are also two lakes in the vicinity.



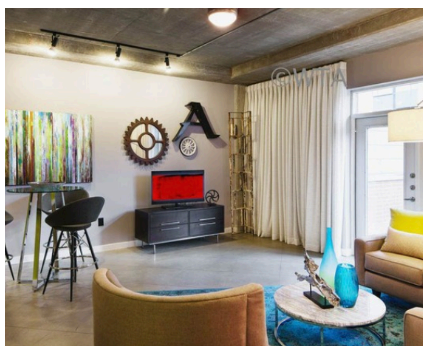
Income taxes in Austin are similar to the income taxes in Houston as the rule of no state income tax also applies. However, income taxes in total would be lower at around $8,200 a year. The property tax rate is also slightly lower at an average of 1.9 percent. These lower rates could be beneficial in the short run, but as I don't see myself living there long enough to purchase property, I do not see it as beneficial in the long run.

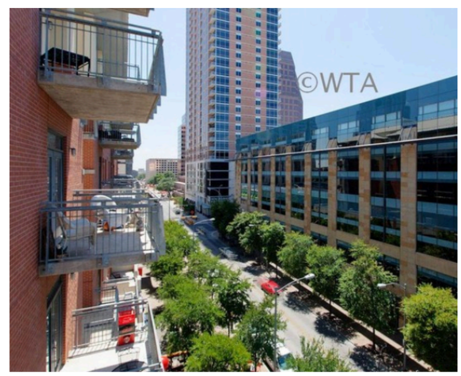
Austin has developed an integrated transportation system downtown called Capital Metro, which includes busses, rail services, and special shuttles during University of Texas game days. These options would be very useful as the downtown area is often difficult to navigate by car due to traffic.

Some of the key industries in Austin include advanced manufacturing and several technological firms. I think that it would be very interesting to audit a company dealing in advanced technology as it would be an opportunity to integrate some of the data analytic programs that we have been learning about in class with new technology. Austin has many outdoor activities for citizens to keep themselves in shape, including miles of running and biking trails. There are also 3 major healthcare systems in Austin, with each having multiple locations around the city. Having a way to exercise outside would be a great change to have after sitting in an office all day once I start my career.

Similar to Houston, the majority of the crimes that take place are centered around theft and breaking into things. In order to prevent this, I would be very vigilant of my surroundings and make sure that I lived in a secure building. The majority of the violent crimes are in the southeastern part of the city, so I would be sure to either avoid this area or use the buddy system when I went to that part of town. Similar to Houston, this level of crime does not dissuade me from moving to Austin as crime is more common in larger cities.

If I was able to sign a 3-year lease for an apartment that I was able to find near downtown, it would be $45,072 over the course of 3 years. The particular unit I found was a 1,281-square foot, 2 bedroom, 2 bathroom unit in a complex with several amenities including a pool and fitness center. There is also in-unit laundry so I would not have to worry about sending out laundry. However, no mention was made of parking arrangements so that would need to be taken into consideration. In order to have a more realistic cost of rent, I would live with one roommate.





Due to the proximity of all of the Austin offices of the Big Four, I would think it would be reasonable to assume that I would be able to walk to work when weather permitted or be able to ride a Metro Bus if there was inclement weather or during the summer when it is very hot. Also based off of the proximity, I would assume that my commute time would be relatively short.

There are many businesses in the area, including a Trader Joe's a few blocks down and multiple smaller grocery stores called Royal Blue Grocery. I feel that this is a decent amount of variety and if I was to live in Austin, I feel that I would be more apt to eat out than to buy groceries and make food at home due to Austin's vibrant food scene.

Some organizations that I would enjoy volunteering my time to if I was to move to Austin would be Austin Pets Alive!, Keep Austin Beautiful, and Ballet Austin. As some of the main things that drew me to Austin is the natural beauty of the area and the thriving arts scene, I think that it would be very fitting for me to give back in both of these areas.

Austin has several music and arts festivals including Austin City Limits (ACL) in October and SXSW Musical Festival in March, both of which I would like to attend. Austin is also home to the University of Texas at Austin and I would love to spend a day cheering on the Longhorns at Darrell K Royal–Texas Memorial Stadium. I would also be sure to take advantage of the multiple lakes in the area by learning how to wakeboard and possibly water ski. I think that all of these activities would be a great way to relive stress after a long week at a firm.

My hometown is only a 2 ½ hour drive from Austin so being able to go back home to see my family would not be an issue. I think that this would be a good distance because it would be far enough away that I could grow as an individual without the constant influence of my family but close enough that if I need them I can hope in the car and be there within 3 hours.

MONTHLY OPERATING BUDGET

Figure 5-2: Monthly Operating Budget - Austin

MONTHLY INCOME – TAXES AND HEALTHCARE	**$4,116**
RENT	**$1,252.00**
UTILITIES	**$100(split 50/50 with roommate)**
CAR INSURANCE + GAS	**$200**
GROCERIES	**$200**
EATING OUT	**$400**
TELEPHONE / DATA	**$250**
ENTERTAINMENT	**$400**
SAVINGS	**$1,314**

4. Conclusion

From this analysis, I have learned that I could see myself liking either city but I believe that I should start my career in Houston, TX. I feel that not only I would fit best in this city personality wise, but there is an immense amount of opportunity. This would be an ideal place to live if I decide that I want to try private accounting after my 3 years at a public firm as there are new businesses opening every day. Also, family is very important to me and the fact that it is also the closest big city to home is a big plus.

Case Study Six

WorldCom, Inc. – Capitalized Costs and Earnings

Quality

1. Introduction

This case was a closer look into the numerical data behind the infamous WorldCom collapse. It also looked into the concept of capitalizing expenses and situations in which it is appropriate to do so and when it is not. This case also required students to replicate what certain figures WorldCom reports would've produced if correct entries were made

I found this case to be very interesting as I was previously familiar with WorldCom and that they had a huge scandal that led to their collapse. However, I was never sure of the specific accounting errors that had been made or what the financial statements that they issued looked like. Through the completion of this case, I was able to explore both of these areas. This was a very helpful case as it was one of the first times that I actually looked at a real-world example of accounting errors and how great of an impact they can have on all of the financial statements and more broadly, the overall financial health of the company.

2. Case Requirements

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

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

The SCON 6 defines an asset as a physical element that a business entity has ownership of that will provide it financial benefits in the future. It continues to define an expense as an asset that is used up while engaging in activities that produce revenue for the entity.

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

As a general rule of thumb, costs should be expensed when they are providing some sort of expansion of production capacity or quality for the entity. Costs should be expensed when they help to maintain the current operational outputs of the asset.

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

When the "costs" are capitalized, they are added to the capital expenditures account. After this, that amount slowly depreciates, similar to manner in which an asset does. The costs are recognized on the balance sheet as an addition to the value of the corresponding asset. As these "costs" are recognized as part of an asset, they are not directly reflected on the income statement. Thus, net income in the period in which theses costs are recognized and capitalized is overstated as they should be recognized as an expense and thus a deduction from revenue.

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

For the year ended December 31, 2001, WorldCom stated that its line costs were 14,739 (in millions).

Line Costs (Expense) 14,739

Cash 14,739

These "line costs" are the expense that WorldCom incurred by paying other companies to access their lines to complete calls for their customers. Short term, one would think this would save the company money as they wouldn't have to invest more in building their lines.

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

The kinds of costs improperly capitalized were the costs that the company incurred to be able to run their day-to-day operations and to produce revenue in the current period, and thus should be expensed in the period that they are incurred, which is in line with GAAP. These costs do not meet my above-mentioned definition of an asset as they are not helping to increase long term capacity or quality of the company's outputs.

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

The journal entry (in millions) to record the improperly capitalized costs would be:

PPE 3,055

Line Costs (Expense) 3,055

On the balance sheet, these costs appeared as part of the PPE section. On the statement of cash flows, they are reflected in the Capital Expenditures section under Cash Flows From Investing Activities.

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

($771/22) * 4/4 = 35.0455

($610/22) * ¾ = 20.7955

($743/22) * 2/4 = 16.8864 ($931/22) * ¼ = 10.5796

Depreciation Expense 83.31

Accumulated Depreciation – Transmission Equipment 83.31

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

Revenues		35,179
Depreciation and Amortization	(5880-83)	(5,797)
Line Costs	(14,739+3,055)	(17,794)
Selling, General, and Administrative		(11,046)
Other Charges		--
Operating Income		542
Other Income		
Interest Expense		(1533)
Miscellaneous		412
Income Before Income Taxes		(579)
Income Taxes (35%)		(203)
Net Income		(782)

I assumed that SG & A, Other Charges, Other Income, Interest Expense, and Miscellaneous would stay consistent with the reported numbers for 2001.

The difference in Net Income would be material as it is a difference of 2,283 (in millions) and takes the company from having a profit to having a large loss.

Case Study Seven

Starbucks Corporation –

Understanding Financial Statements

1. **Introduction**

The purpose of this case was to expose students to various financial statements from a Fortune 500 company and allow them to answer questions that guide them to begin thinking as an auditor does when viewing financial statements. This case was also used as a way to get students to understand the connections between financial statements and how they must all work together in order to create an accurate picture of a corporation's financial standing. This case also allowed students to see how one-time events can leave a large mark on and effect many of a company's financial statements.

From this case, I now have an example of what real financial statements from a large company actually look like in practice. Before this case, I had also never seen an actual opinion given by an audit team. I found this very interesting as there is not a lot of material featured on the audit report compared to the amount of work that is put in. I think that this was a great introduction to analyzing an entire financial profile for a student like me who had not previously been exposed to these documents in their entirety.

2. **Analysis**

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

The nature of Starbucks' business is that they are a food service company with a retail division. They make money by fulfilling customer's orders for food and drinks, and also sell various kinds of merchandise and coffee products.

b. 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 are the income statement, the balance sheet, and the statement of cash flows. In the case of Starbucks' financial statements, they have presented them in a condensed form. This means that they are almost just a summary of the financial position of the company and do not include as much detail as a normal financial statement would.

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

Publicly traded companies must prepare financial statements for external reporting four times a year. These documents are called 10-Qs. Additionally, they must present cumulative financial statements at the end of the year. These are called a 10-K.

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

In the case of Starbucks, their internal accounting division and parts of their upper management would be in charge of creating their financial statements. The potential users of these statements could be both internal and external. Internal users could include upper management and they might be most interested at looking at expenses and how they could be reduced.

External users may include potential investors, Starbucks' creditors, stockholders, and government agencies. Potential investors may be interested in the company's overall profit levels and what their investments into the future of the company are. Starbucks' creditors may be interested in different ratios presented in the financial statements, including their times interest earned and their liquidity ratio. Stockholders may be interested in what their earnings per share are, both diluted and undiluted. Government agencies may be interested in information concerning how much they are paying in taxes and if the financial statements overall are following all of the guidelines set in place by the FASB.

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

Starbucks' external auditors are Deloitte & Touche LLP, based out of Seattle, WA. Starbucks received two "letters" from their auditors, one concerning the reliability of their financial statements and one addressing their internal controls. The letter describing their financial statements detailed what the audit covered and where the guidelines they followed were coming from. They concluded by stating that Starbucks' financial statements were a fair representation of their financial standing. The second letter, concerning internal controls, similarly detailed the audit process, what management's role in the internal controls of the corporation are and where the guidelines for internal controls can be found. It also concluded by stating that Starbucks had effective internal controls.

f. At end of document

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

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

The accounting equation still holds true for Starbucks, even though it is a large corporation. This can be seen when comparing cells B19 (Total assets) and B38 (Total Liabilities and Equity). This completes the accounting equation as it is Assets = Liabilities + Equity and the cells representing these amounts are indeed equal.

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

Starbucks' major assets include Cash and Cash Equivalent and Property, Plant, and Equipment. Short-term assets constitute 47.51percent of total assets and long-term assets make up the other 52.49 percent of total assets. It would make sense for Starbucks to have such a high amount of cash and cash equivalents as the majority of their customers pay in a way that provides them with immediate access to their funds. Also, in the food service industry it makes sense to have a lower amount of inventory as food products typically have a very short shelf life and it would be very wasteful to have a large amount of inventory that would have to be constantly thrown out. It also makes sense that they would proportionately have a high amount of PPE as they have to invest in a lot of specialty equipment for franchise in order for it to be operational.

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

Intangible assets are assets that lack physical existence and are not financial instruments. Goodwill is technically defined as the measurement of "the excess of the cost of the purchase over the fair value of the identifiable net assets (assets less liabilities) purchased. Some specific intangible assets that Starbucks might have include copyrights over their logo, trademarks on their name itself, or goodwill that is created when it purchases smaller coffee companies. Another possible intangible asset would be franchise licenses.

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

A large portion of the funds that the corporation brings in can be contributed to the fact that they either sold or called many of their long-term investments and some of them also matured. They also issued a decent amount of long-term debt. About 23.56 percent of Starbucks' financing comes from outside investors (C27 + C28).

h. **Review the revenue recognition policies of Starbucks discussed in Note 1 (Summary of Significant Accounting Policies).**

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

For stores that are wholly operated by the company and are not franchises, revenue is recognized when they receive it from their customers. For franchised stores, payment is received from franchisees when they receive official inventory from the parent company. The company recognizes revenue from gift cards when they are redeemed by customers or when the likelihood that they will be redeemed by customers is very low. The outstanding balances on these cards is regarded as deferred revenue and the cards have no expiration date. One challenge in matching revenue that I can see is if a customer buys a gift card and then does not use it for many years, it would be very difficult to match that revenue with the costs associated with attaining it due to the large gap in time. Also, customers, especially at a business like Starbucks, are more likely to either use their gift card as soon as they obtain it or are likely to almost forget about it and use it at a faraway future time. Management might need to consider general customer behavior relating to gift cards when determining how to address the revenue they create.

ii. **What are Starbucks' major expenses?**

The main expenses that Starbucks incurs include their cost of sales including occupancy costs (41.26 percent), store operating expenses (27.71 percent), and a litigation charge (18 percent).

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

One significant change in the cost structure is the fact that they had the additional cost of a litigation charge. This was not present in prior years. Also, in 2013 their cost of sales including occupancy costs dropped by almost 10 percent compared to the previous years. Overall, they also had a small decrease in the rest of their operating expenses.

iv. **In fiscal 2013, Starbucks separately reported a litigation charge and included it in operating income. Why didn't the company just include**

this amount within the line item for general and administrative expenses? Why is it an operating expense?

The reason that the litigation expense is not part of the general and administrative expenses is general and administrative expenses are generally not able to be linked to the production of a certain product or the completion of a specific service. As for a litigation expense, it is very easy to track what the expense is producing - defense for the corporation in a court of law.

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

Mathematically, Starbucks was "profitable", but only after refunds for income taxes. If total net revenue and total operating expenses are the only things that are compared, then Starbucks operated at a loss in 2013. This loss looks even worse when you compare it to the previous years and see what a dramatic decrease it is.

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

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

The difference in these ow figures, net earnings at 8.8 and 2908.3 can be attributed to the fact that there was a large amount of income taxes that they were able to defer due to their lack of profit for the fiscal year.

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

They used $1,151,200,000 in cash on property, plant, and equipment during the 2013 fiscal year.

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

In 2013, Starbucks declared dividends of $543.7 and ended up paying $628.9 in cash dividends, according to the statement of cash flows.

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

Accounts on Starbuck's balance sheet that may require estimates are the inventory account, the goodwill account, and long-term debt accounts that are recorded at fair value, accounts receivable, PPE due to the estimate of useful life used in depreciation. Some accounts that may be estimate free are cash and cash equivalents, deferred income taxes, accounts payable, and accrued litigation charge.

Figure 7-1: Common-Size Balance Sheet

Consolidated Balance Sheets (USD $)	Sep. 29, 2013	Scaled	Sep. 30, 2012	Scaled
In Millions, unless otherwise specified				
Current assets:	'		'	
Cash and cash equivalents	$2,575.70	**22.36%**	$1,188.60	**14.46%**
Short-term investments	658.1	**5.71%**	848.4	**10.32%**
Accounts receivable, net	561.4	**4.87%**	485.9	**5.91%**
Inventories	1,111.20	**9.65%**	1,241.50	**15.10%**
Prepaid expenses and other current assets	287.7	**2.50%**	196.5	**2.39%**
Deferred income taxes, net	277.3	**2.41%**	238.7	**2.90%**
Total current assets	5,471.40	**47.51%**	4,199.60	**51.09%**
Long-term investments	58.3	**0.51%**	116	**1.41%**
Equity and cost investments	496.5	**4.31%**	459.9	**5.60%**
Property, plant and equipment, net	3,200.50	**27.79%**	2,658.90	**32.35%**
Deferred income taxes, net	967	**8.40%**	97.3	**1.18%**
Other assets	185.3	**1.61%**	144.7	**1.76%**
Other intangible assets	274.8	**2.39%**	143.7	**1.75%**
Goodwill	862.9	**7.49%**	399.1	**4.86%**
TOTAL ASSETS	11,516.70	100.00%	8,219.20	100.00%
Current liabilities:	'		'	
Accounts payable	491.7	**6.99%**	398.1	**12.82%**
Accrued litigation charge	2,784.10	**39.58%**	0	**0.00%**
Accrued liabilities	1,269.30	**18.04%**	1,133.80	**36.52%**
Insurance reserves	178.5	**1.55%**	167.7	**5.40%**
Deferred revenue	653.7	**9.29%**	510.2	**16.43%**
Total current liabilities	5,377.30	**76.44%**	2,209.80	**71.18%**
Long-term debt	1,299.40	**18.47%**	549.6	**17.70%**
Other long-term liabilities	357.7	**5.09%**	345.3	**11.12%**
Total liabilities	7,034.40	**100.00%**	3,104.70	**100.00%**
Shareholders' equity:	'		'	
Common stock ($0.001 par value) - authorized, 1,200.0 shares; issued and outstanding, 753.2 and 749.3 shares (includes 3.4 common stock units), respectively	0.8	**0.01%**	0.7	**0.01%**
Additional paid-in capital	282.1	**2.45%**	39.4	**0.48%**
Retained earnings	4,130.30	**35.86%**	5,046.20	**61.40%**
Accumulated other comprehensive income	67	**0.58%**	22.7	**0.28%**
Total shareholders' equity	4,480.20	**38.90%**	5,109	**62.16%**
Noncontrolling interests	2.1	**0.02%**	5.5	**0.07%**
Total equity	4,482.30	**38.92%**	5,114.50	**62.23%**
TOTAL LIABILITIES AND EQUITY	$11,516.70		$8,219.20	

Figure 7-2: Common-Size Income Statement

Consolidated Statements Of Earnings (USD $) In Millions, except Per Share data, unless otherwise specified	Sep. 29, 2013	Scaled	Sep. 30, 2012	Scaled 2	Oct. 02, 2011	Scaled 3
Net revenues:						
Company-operated stores	$11,793.20	**79.19%**	$10,534.50	**79.21%**	$9,632.40	**82.33%**
Licensed stores	1,360.50	**9.14%**	1,210.30	**9.10%**	1,007.50	**8.61%**
CPG, foodservice and other	1,738.50	**11.67%**	1,554.70	**11.69%**	1,060.50	**9.06%**
Total net revenues	14,892.20		13,299.50		11,700.40	
Cost of sales including occupancy costs	6,382.30	**41.26%**	5,813.30	**50.49%**	4,915.50	**48.31%**
Store operating expenses	4,286.10	**27.71%**	3,918.10	**34.03%**	3,594.90	**35.33%**
Other operating expenses	457.2	**2.96%**	429.9	**3.73%**	392.8	**5.14%**
Depreciation and amortization expenses	621.4	**4.02%**	550.3	**4.78%**	523.3	**5.14%**
General and administrative expenses	937.9	**6.06%**	801.2	**6.96%**	749.3	**7.36%**
Litigation charge	2,784.10	**18.00%**	0	**0.00%**	0	**0.00%**
Total operating expenses	15,469		11,512.80		10,175.80	
Gain on sale of properties	0		0		30.2	
Income from equity investees	251.4		210.7		173.7	
Operating income	-325.4		1,997.40		1,728.50	
Interest income and other, net	123.6		94.4		115.9	
Interest expense	-28.1		-32.7		-33.3	
Earnings before income taxes	-229.9		2,059.10		1,811.10	
Income taxes	-238.7		674.4		563.1	
Net earnings including noncontrolling interests	8.8		1,384.70		1,248	
Net earnings attributable to noncontrolling interest	0.5		0.9		2.3	
Net earnings attributable to Starbucks	$8.30		$1,383.80		$1,245.70	
Earnings per share - basic	$0.01		$1.83		$1.66	
Earnings per share - diluted	$0.01		$1.79		$1.62	
Weighted average shares outstanding:						
Basic	749.3		754.4		748.3	
Diluted	762.3		773		769.7	

<u>**Case Study Eight**</u>

BP p.I.c -- Contingencies

i. Introduction

This case dives into the consequences the Deepwater Horizon oil spill had on BP's financial statements in the year 2010. The Deepwater Horizon oil spill began with an explosion on April 10, 2010 that killed 11 people and caused a leak in an underwater oil pipe off the coast of Louisiana. This leak would not be capped for 87 days and would allow an estimated 31.9 million barrels of oil to contaminate the Gulf of Mexico. It is now considered to be the worst oil spill in U.S. history and many coastal areas, as well as wildlife, are still dealing with the ramifications of this horrendous event.

The purpose of this case was to show students to the concept of contingent liabilities in a real-world application that hits close to home, especially to those from the Mississippi Gulf Coast. This case also allowed students to explore all of the different aspects that are taken into account when estimating these liabilities and when there may not be enough information to accurately predict this amount. Personally, from this case I learned how difficult it can be to actually quantify the damage that a spill like this has on a company's financial statements. I also learned about how the coast is still financially recovering from this disaster almost 10 years later.

By exposing students to this topic, they are more equipped to see current events and automatically thing of not only the obvious effects, whether those be political, environmental, social, or many other things, but how they may have a lasting financial impact on those businesses and markets involved.

ii. Case Requirements

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

A contingent liability is a liability that may or may not actually occur and is based on an uncertain future event. A company would record a contingent liability when there is an event that would cause the company to incur a loss or an expense that they believe is likely to happen and this likelihood can be reasonably estimated. Examples of contingent liabilities include likely lawsuits and warranties, as these are both expenses that can be reasonably estimated but whose exact magnitude will not be known until the actual event occurs. Companies do not record contingent assets such as a contingent gain as this would violate the very conservative nature of accounting as a profession.

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

From the perspective of BP, the warranty can be seen as a type of prepaid asset – it is a sort of insurance policy for anything that may happen to the equipment. In the event that anything is defective, they will have an amount that will cover a part of or the whole amount to replace the defective part. From the perspective of GE Oil and Gas, this warranty would be recorded as unearned revenue with an allowance account for the amount of the warranty also being created. Once the warranty is redeemed by the buyer, the revenue would be recognized, along with the associated expenses. The liability would also be reduced at this time.

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

Some judgements that need to be made by management in order to accurately account for contingent liabilities is what the scope of the incident may be and what lasting effects it might have. They also need to take into account if there may be any additional costs in the future that are currently undetectable. Accrued warranty costs may be difficult to estimate. In some instances historical data may be able to be used to accurately estimate this cost for similar products, but in the case of new products, things that may need to be taken into account include the material of the product, the normal life of the product, and what the product is used for and how this usage may lead to a shortened product life.

A claim for damages resulting from the Deepwater Horizon oil spill would be different than a normal warranty claim in the fact that it was not a foreseeable or likely event. It is very unlikely that BP assumed that some sort of catastrophic event would happen and added this doubt into their financial statements. Even if they did do this, it is not probable that they estimated a large enough amount to cover the resulting damage. Compared to a normal warranty claim, there is also really no amount of insurance that BP would be able to purchase from an equipment supplier that could be enough to cover this, nor would an equipment supplier be likely to offer this kind of coverage.

This claim would also be one that BP may have little ability to place to liability on another company. Even though there might have been a defective part that caused the explosion, it is also possible that the pipe was improperly sealed during its installation, a problem that would fall back on BP. Also, with an operation as large as offshore drilling, it is certain that there were multiple parties involve, each of which were declared to have a different percentage of the blame and thus the financial responsibility. However, BP still had the largest amount of this blame, perhaps because they received the largest amount of the profit from this venture.

d.

1. **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.**

Some estimates that BP had to take into account when calculating the contingencies associated with the Deepwater Horizon oil spill were costs initially assigned by a Unified Area Command, costs associated with ongoing clean-up efforts, containment efforts, relief well drilling, grants to states whose shorelines had been effected, claims that were already made, and any expected legal costs to be incurred. They would also have to consider any sort of fine that they would be incurring but, this amount would be a little easier to estimate as it would be coming from the government and can be calculated based on a few different factors.

The largest contingency that would have to be accounted for is for future litigation. As this occurred as the country was attempting to crawl its way out of a great recession, business on the gulf coast had already taken a hit. As many areas on the coast rely on tourism as a large part of their revenue, it was devastating to have the very beaches that brought in tourists covered in oil and debris. Not only was the tourism industry affected, but all off-shore fishing had to be halted as the fish being pulled out of the gulf were temporarily unfit for consumption. This heavily damaged the fishing industry on the coast and caused many to lose their livelihoods.

Additionally, the overall loss of income and degradation of the economy in the region caused many to migrate from the area, affecting many businesses that are essential to any community, regardless of if they are coastal or not. This category could include anything from grocery stores to gas stations to retail stores who served permanent residents of the area. As people have slowly started to return, the economy has begun to bounce back, but those businesses who were not able to weather the "storm" are long gone from the picture.

After looking deeper into the effects of the spill on residents of the coast, I found that there were many cases where those who came into contact with the oil actually developed medical conditions such as leukemia and continuous seizures. Since medical professionals have been able to link a good amount of these cases to the contaminated water, BP may even be liable for any medical expense incurred by these individuals. However, it may be difficult for an individual who sues to prove that it is only able to be linked to their exposure and not any kind of pre-existing condition they may have had.

2. **If you were the auditor for BP, how would you draw a boundary around the potential losses suffered from the Deepwater Horizon oil spill?**

I think that it would be very difficult to figure out where the line should be drawn as the effects of this tragedy are still being felt today, something that would have been very difficult to decide in the spring of 2010. However, I think that there a few constraints that can be applied in order to contain the amount of the loss. For example, medical lawsuits would probably take up a very small amount of the liability as most of the cases would be very difficult to actually prove in court unless the prosecution had concrete evidence against BP. It would also be less complicated to estimate the liability that BP would have in fines to the government as that is something that has precedence and can be easily calculated. What would not be simple to calculate would be the possible negligence civil cases brought against them by individuals. However, it may be possible to get a rough estimate of this cost after it is taken into account that most civil cases have a statute of limitation of two years. After the two-year mark- 2012- it is very unlikely that anyone would be able to personally sue the company for negligence in a civil court and be successful.

In the context of having the discussion with an audit team about what a reasonable cap on the liability estimate would be, I think that it would be very important to have all team members approach it from a different angle – some looking at possible injury suits, some at possible lost income suits, and some at definite fines they would face from the government. Attacking the problem from this approach would ensure that all areas were covered and there was no section that was overlooked. Another tactic that could be used is to look at similar situations, such as the Exxon Valdez and how it affected the long-term financials of Exxon.

Case Study Nine

The Wendy's Company

Equity Method Investments

i. Introduction

This case focuses on the finances behind joint ventures- in particular the joint venture between the Wendy's corporation and Tim Horton's, a Canadian-based fast food chain. The case covers various aspects of the merger including how Wendy's condensed income statement and balance sheets are affected. It also introduces students to a real-life example of a company who uses the equity method to value their investments.

Overall, I thought that this was a very helpful case as it did not only expose me to the actual accounting behind mergers and the equity method, but it was also the first time that I was able to look at different financial statements and figure out where the specific figures were coming from and how they were significant in the context of the entire audit.

ii. Case Requirements

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

There are many reasons that companies agree to enter into joint-venture agreements. One of these is the reduced risk and pledge of assets in order to enter a new business venture. When going into an agreement with a partner, the companies only have to provide half the resources and only take on half the risk of a project, compared to the full amount they would be liable for if they approached the project alone.

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

The equity method is a way that businesses are able to account for the financial situation of a company that they have significant ownership in. In order to have significant ownership, they have to have 20-50 percent ownership (own 20-50 percent of the company's stock) and be able to assert significant influence (have a say about the actions of the company at the company's board meetings). In order to account for their initial investment, the parent company records a debit to an equity investment account and credit to cash. This sets up an account that is then able to be adjusted when necessary for things such as net income of the subsidiary (the company that the parent company has a controlling interest in), dividends payed by the subsidiary, and any gains or losses that the subsidiary might have.

There is a specific way that these changes in the financial position of the subsidiary are recorded on the parent's financial records. Whenever the subsidiary reports net income, the parents company accounts for this by debiting the Equity Investment account created for that subsidiary and crediting Investment Income. By doing this, the parent company is able to keep the same ownership percentage of the subsidiary as net income increases the value of a company. The opposite of this would be when the company experiences a loss; in that case, the parent company would debit Investment Loss and credit Equity Investment. This also makes sure that the ownership proportion stays the same.

When the subsidiary pays dividends, the parent company records this as a debit to Cash and a credit to Equity Investments. As the parent company owns a percentage, the amount that they recognize in dividends, net income, and losses is calculated by multiplying the total amount reported by the subsidiary by the parent company's ownership percentage.

There are a few reasons that this method is preferred for ownership percentages where the parent company has significant influence over the subsidiary. One is that this method allows the parent company to incorporate the income of another company directly into their income statement as it is assumed that if a company has a large stake in another or is in a joint venture that used this kind of valuation method that the profits from this other business would significantly impact their financial statements.

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

In order to compute the value of the investment, the parent company records this investment in their books as the amount that they paid.

However, sometimes the amount that the company pays is more than what the assets are valued at on the subsidiary's books. In this case, when the parent company pays more than the value of the equity per share, this excess value is divided into two categories: acquisition accounting principle and goodwill. When this occurs, this excess purchase price, called the acquisition accounting premium or AAP, has to be allocated to the assets of the investee (ex. Identifiable assets and liabilities) in order to write their value up to what is considered to be their fair value at the time that the investment is made.

The amount that isn't used to write up A&L will be included in the parent company's goodwill. Goodwill is an account that contains the value of non-monetary assets, such as value added by the public image of the company. Additionally, this goodwill account will then have to be annually tested for impairment; a process that makes sure that the company isn't overstating the account's value. This impairment of goodwill will also be featured on the parent company's income statement. In the case of the TimWen joint venture, the amount that is used to write up assets purchased by Wendy's won't be depreciated on Tim Horton's books. Instead, it will create an annual charge on the parent's side (Wendy's) to depreciate the amount within the equity investment account. Since Wendy's only owns a portion of the company, they would multiply the total depreciation amount by their ownership percentage in order to find the amount of depreciation that they need to account for.

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

In 2011, it included $119,271 as its investment amount. This is the sum of both their equity investments and cost investments. The purpose of note 8 is to then further explain how this amount was calculated. In 2011, they state that this amount is $113,533**.** These amounts are presented on the consolidated income statement in the investments section under long-term assets.

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

On the financial statements for 2012, it is disclosed that Wendy's had made an investment of $89,370 in a joint venture with Tim Horton's. After looking farther into note 8, it is discovered that by the end of the financial year ended December 30, 2012, Wendy's investment in TimWen exceeded the underlying equity of the joint venture by $54,088. The difference in these two amounts is $35, 282. The $54,088 can be labeled as the excess amount that Wendy's paid over the market value to enter into this joint venture with Tim Horton's. This is also the amount that will be broken into AAP and goodwill as time goes on. One reason that Wendy's may have paid this amount was that they thought it was a fair price to pay for the potential benefits that entering into this joint venture with Tim Horton's would be.

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

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

      In 2012, earnings before taxes for the TimWen joint venture were $13,680 and they were $13,505 in 2011. This is an amount that was then added to the company's overall net income. This amount was then netted with the corresponding expenses and is shown in the other operating expense, net section of the company's condensed statement of operations.

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

      Wendy's share of TimWen's 2012 earnings is $13,680. The journal entry to record this amount is as follows:

Equity Investments	13,680	
Equity Income		13,680

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

The amount of amortization in the purchase price in 2012 was $3,129. Below is the journal entry to record this:

Equity Income 3,129

Equity Investment 3,129

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

In 2012, Wendy's received $15,274 in dividend and in 2011 they received $14,924. Below is the journal entry to record this dispersion in 2012:

Cash 15,274

Equity Investment 15,274

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

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

In order to compute this amount, it is necessary to deduct net income from equity investments because under the equity method, the company never actually received cash from the net income percentage made by their subsidiary. Additionally, any dividends that may have been paid out from the subsidiary were never recorded as income, so they have to be added into the parent company's net income. In order to compute this amount for Wendy's financial statements for 2012, you have to combine $10, 551from TimWen (balance in equity account after adjustments for earnings and amortization) and the $1,827 loss from their investments in Japan. This amount has to be subtracted because as a loss, it is a deduction from the overall investment accounts. The next step would be to add to the cash from operating the dividends that Wendy's received from the TimWen joint venture.

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

This amount is added to Wendy's financial statements under the section "Distributions Received from Joint Venture" as it is the same amount that is disclosed in note 8 under "Distributions Received" in relation to the adjustment of the value of the equity account. A positive adjustment is made to net cash from operating activities in this case because when dividends are recorded under the equity method, there is a debit to Investment Income and a credit to the Investment Account. However, this investment income does not directly flow through the income statement, so the adjustment is necessary in order for the income of the company to be faithfully represented on the financial statements.

Case Study Ten

Johnson & Johnson

Retirement Obligations

i. Introduction

This case was an analysis of the retirement obligations that Johnson & Johnson has to its retired employees and the financial planning that it has implemented in order to attempt to cover this amount. In this case, it was also necessary for students to look into the financial statements of the company in order to figure out where the changes in the plan assets and retirement benefit obligation are reflected and what can be learned from these amounts. This case also required students to pull together information from multiple financial statements and footnotes – a skill that is required to be successful in the professional accounting world.

I found that this was a very helpful case as it was the same topic that was being covered in several of my other classes at the time. Not only did it further enforce the concepts that I was learning in my intermediate accounting class, but it gave me a chance to see how they were enacted in the business world. By looking into actual financial statements in order to find the necessary information to complete this case, I was also able to gain an enhanced understanding of a section of the financial statements that I was previously unaware of. Overall, I believe that this case was very beneficial to students as retirement benefits are something that is a component of every public company and an understanding of how they function will be a necessity for any student who hopes to have a successful career in public accounting.

ii. Case Requirements

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

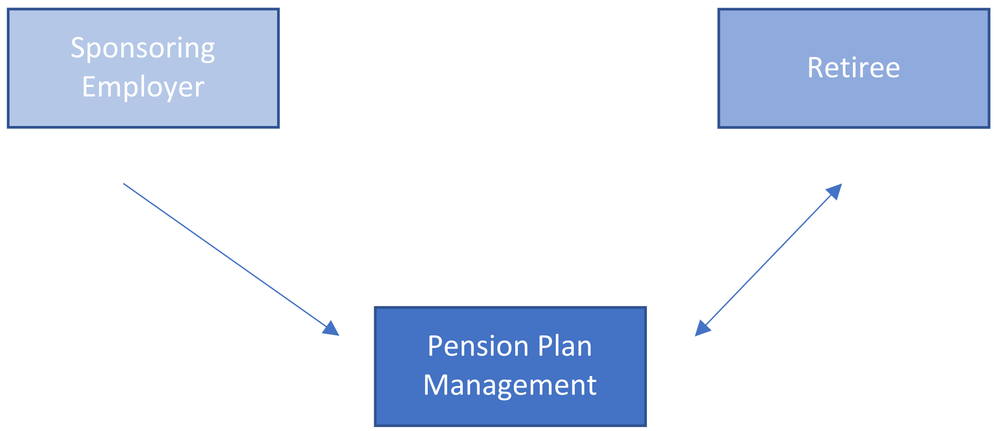
i. How do these two types of plans differ? Which type does Johnson & Johnson have?

A defined benefit plan is a retirement plan in which a company guarantees their employees certain benefits when they retire, such as a salary that is a certain percentage of an average of their highest three years' salaries. As this is often a very difficult amount to estimate and leaves the company with an outstanding liability, more and more businesses are switching to a defined contribution plan. A defined contribution plan is a retirement plan in which an employer contributes a certain amount of an employee's salary to a retirement fund on their behalf and may match what the employee contributes. This is preferred by many companies because the majority of the responsibility of wisely investing for retirement is shifted to the employee.

Both of these plans also rely on if an employee is vested or not. If an employee is "vested", it means that they have been employed at a company beyond a certain amount of years, known as a vesting period, and are now eligible for retirement benefits. This concept is used to protect employers from being obligated to pay those who have worked for them for a short amount of time retirement benefits.

ii. Explain why retirement plan obligations are liabilities.

Figure 10-1: Retirement Plan Obligation Explanation graphic



This liability is created by the relationship between three entities – the sponsoring employee, the retiree, and an outside pension plan management company. Both the sponsoring employee and retiree pay into a fund managed by the pension plan management. This amount is then invested by the outside company in the hopes that this will grow into a fund large enough to cover benefits for the employee once they retire. However, even though the employer now has some sort of financial ability to cover this amount, they are still liable to the employee for whatever amount is defined by the defined benefits plan. An additional interaction between the management company and the retiree also happens when the management company pays the retirees their benefits.

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

Some obligations that are necessary in order to account for retirement plan obligations include how long the employee is expected to live and the health of the employee, the salaries that the employee has made during their career at the company, how long they have worked at the company, and what the return rates on the market are.

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

Service cost is the extra cost the company incurs every year that is related to the employee that the plan is for working another year. This helps to account for the extra amount they will have to pay the employee when they retire due to the fact that they were employed for another year and is added to the pension expense. Interest cost is the amount of interest that the sponsoring company has to pay on the projected benefit obligation. This amount is found by multiplying a rate, often called the **interest rate**, by the beginning balance of the projected benefit obligation. This is also added the pension expense.

Actuarial gains or losses are adjustments that have to be made to the PBO due to changes in the estimates made by actuaries. Factors that might cause a gain include lower salaries and average shorter lifespans. Oppositely, a raise in salaries and a longer average lifespan may cause an actuarial loss. Benefits paid to retirees is the actual amount that is paid to those who are already retired. This distribution is subtracted from the PBO as this is an amount that is no longer owed to the retirees.

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

Actual return on pension investments is the amount that companies add to their pension assets based on returns they received on their investments. It is very typical for companies to have third parties invest a portion of their plan assets in order to grow these assets and to simultaneously offset their projected benefit obligation. This amount is added to the plan assets balance. Company contributions to the plan consist of the amount of funds that the company dedicates to the plan assets. It is very common for these funds to be directly added to the balance of the plan assets. This amount is also added to the balance of the plan assets.

Benefits payed to retirees is the amount that is actually paid to those employees who are retired and drawing benefits. It is subtracted from the plan assets as this is an amount that is no longer held in the assets.

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

One difference in these is the amount that is recorded for both components. When recording the amount for return on plan assets for pension expense, the expected return on the plan assets is used. This is because at the time that the pension expense is calculated, the actual return on the plan assets is unknown. When the amount is calculated for the actual return on plan assets, the actual percentage return is used as it is known. In order to reconcile for the potential difference in these amounts, companies book this amount to both pension expense as an unexpected gain or loss and to other comprehensive income as either a gain or loss.

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

   Note that the company uses the term "net periodic benefit cost" to refer to pension expense.

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

      In 2007, Johnson & Johnson reported $646,000,000 as pension expense.

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

Pension Expense 1,243,000,000

PBO 1,243,000,000

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

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

At December 31, 2007, the value of the company's retirement plan obligation is $12,002,000,000. This value represents the amount that Johnson & Johnson owes to employees who have retired and are drawing benefits and the amount that they are projected to owe those who they currently employ and will be able to draw retirement benefits in the future. This amount can be regarded as reliable for the time it was released as long as it is known that it is very likely that this number will change as it is based on many factors that are constantly changing.

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

The pension-related interest cost for the year is $656,000,000. By using this amount and the projected benefit obligation at the beginning of the year of $11,660,000,000 and the associated adjustment of $14,000,000, the average interest rate the company must have used to calculate interest cost is 5.62 percent. This rate seems to be reasonable as it is between the discount rate that Johnson & Johnson uses for domestic plans (6.50 percent) and the rate of 5.50 percent that they use to calculate interest for the pension plans they have for their international employees.

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

In 2007, $481,000,000 was paid to retirees. Johnson & Johnson did not pay cash for these benefits as this amount is paid from the plan assets. The payment of these benefits both decreases both the retirement plan obligation and the retirement plan assets.

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

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

At December 31, 2007 the value of the retirement plan assets held by Johnson & Johnson is $10,469,000,000. This value is the amount of assets that Johnson & Johnson has "set aside" to pay retirement benefits to those who qualify for them as they become due.

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

In 2006, the expected return on plan assets was $701,000,000 and the actual return on these assets was $966,000,000. The difference in these amounts is $265,000,000. I believe that this is a significant difference, but as this would be a gain for the company, it is a positive difference. In 2007, the expected return on plan assets was 809,000,000 and the actual return on these assets was $743,000,000. This difference is only $66,000,000, which is still significant as it is an unexpected loss, but the magnitude of this loss is decreased when comparing it to the gain in the prior year. I believe that the return in 2007 better reflection of the company's interest expense as it is much closer to the amount that the company reported as interest expense.

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

In 2007, Johnson & Johnson contributed $317,000,000 and their employees contributed $62,000,000 for a total of $379,000,000. This is an $11,000,000 increase from the 2006 total contributions of $306,000,000.

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

The type of investments that are in Johnson & Johnson's retirement plan assets are equity and debt securities.

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

The plan is underfunded in both 2006 and 2007, though it is more underfunded in 2006. This amount is shown on the balance sheet as Employee Related Obligations (Notes 5 and 13).

Case Study Eleven

On the Balance Sheet-Based Model of Financial Reporting

i. Introduction

For this case, we were given an article entitled *On the Balance Sheet-Based Model of Financial Reporting*. The basis of this article was, as stated in the title, if financial reporting should continue to operate on the current compromise between the balance sheet model and income statement model or if going to a more direct interpretation of either of these would be a better decision.

This article started by giving the reader a brief history of financial accounting, including how over the years it has shifted from being purely income statement method based to the conglomeration of this and the balance sheet method that it is today. The author then begins their argument as to why this current method is not the most ideal. They give several reasons why they believe this is true and then conclude by stating their solution to this problem that incorporates an emphasis of the separation of operating and financing assets and how these should be accounted for.

From reading and digesting this case, I have found myself wondering what other accounting foundations could possibly be looked at from a different angle and if there would be a more efficient and effective way to present financial statements. This article will give me an edge on my peers as the concept of the balance sheet method versus the income statement method was never thoroughly discussed in any of my previous accounting classes. This article also gave me the opportunity to discuss this topic with my peers, something I had definitely not been able to do before.

ii. Requirements

a. Summary of Article

Similar to the structure of our case studies, this academic paper was split into multiple sections: Introduction, History and background for the current developments, A critique of the balance sheet-based model of financial reporting, Suggestions about what a "better" conceptual framework might look like, and the Conclusion.

The introduction section served as a small glimpse into the current project of the FASB and the IASB- the reconsideration of their conceptual frameworks. It covered the fact that both of these organizations are currently operating under different standards, but in the process of attempting to make a compromise between these two systems, have completely failed to consider that they may want to move away from the balance-sheet method of account and move towards the income statement approach.

The second section of this article covered the History and background for these current developments and gave a brief history of the different methodologies of accounting itself. Over the course of the history of accounting, there has been a strong disconnect in whether financial statements should be based on a balance-sheet approach or an income statement approach. In a balance-sheet approach, the main goal is to be able to properly report the value of assets and liabilities. In order to calculate amounts that are found on the income statement, it would then be necessary to find the change in the valuation of assets and liabilities over the fiscal period.

On the other hand, the income statement approach focuses on determining the business's revenues, expenses, and earnings. It has a strong emphasis on both the revenue recognition principle and the matching principle in order the ensure that these amounts are correct for the period. The revenue recognition principle states that revenue can only be recorded once it is actually earned. The matching principle states that these earned revenues then need to be "matched" or displayed on the financial statements in the same period that the expenses that were incurred in order to create these revenues were also displayed. Most investors prefer the income statement approach as it is much easier to determine a company's earnings and thus valuate their stock.

When looking at financial accounting as a whole, the most accepted methods of reporting financial statements have typically been a combination of the balance sheet and income statement approaches. Interestingly, the income statement method was far more accepted by the accounting community and was actually the standard up until the creation of the APB and later the FASB led to a change in these standards as it became evident that piecing things together from both methods was no longer doing to be effective. In the late 1970s, after considering how any change to the conceptual framework of accounting would drastically affect the business world, the FASB decided that financial statements would now be based off of the balance-sheet approach.

In somewhat of a “what came first, the chicken or the egg” debate, they stated that the reasoning behind this decision was that earnings were defined as a “change in value” and there is no true way to figure out what that change is until you determine what the “value” is. As time has progressed and issues have arisen, many more standards have been set, including at move toward complete “fair value” accounting. This decision has also affected accounting internationally as the conceptual framework issued by the IASC in 1989 is also heavily based off of the conceptual framework created by the FASB.

The author then moves towards introducing some of the FASB’s more recent work, specifically the introduction of a new Preliminary View in 2006. This Preliminary View has the purpose of reducing the inconsistencies between the two frameworks, something that the author heavily disagrees with as thy believe that the entire system needs to be looked at on a deeper level.

After giving the reader a summary of the principles behind financial accounting, the article moves into the author’s main argument- that the current conceptual framework has multiple issues, most stemming from the fact that it is based on the balance sheet method and not the income statement method. The author splits their argument into four main points- that the balance sheet method does not fall in line with how businesses are operated, that the superiority of the balance sheet method is subjective at best, the balance sheet method is contributing to the declining usefulness of projected future earnings, and the balance sheet method has multiple issues in actual practice. Each of these points is then backed up with very detailed and compelling evidence, including the idea that from a balance-sheet approach, assets are seen as something that holds value and thus the change in their value represents income whereas in the actual business world income is created from the usage of these assets and not simply by owning them.

The end of this article is interesting as it actually attempts to give a solution on what can be done to solve these alleged problems instead of simply stating that they exist. The author first proposes that there be a distinctive difference between what constitutes an operating and an investing activity. They then state that this distinction should be emphasized on all financial statements, specifically in separating which firm-generated income comes from day-to-day operations (and can thus be a strong determining factor in the future financial health of the firm) and income that arises from financial assets, which are subject to a large amount of change. They also propose that assets held by the firm should also be separated into operating and financing sections in order to give investors a clearer view of how asset valuation is actually held in the firm.

The author then goes to state that the principles of revenue recognition and matching need to be more thorough in their explanations and the provisions that follow these principles need to be more exact. The author then ends this section with asserting that the matching principle and the revenue recognition principle should actually be the foundation of financial accounting and one of the main reasons why the current structure is so dysfunctional is because these two principles are not at its core.

The paper ends with a conclusion section which simply restates that since the FASB is currently reconsidering its accounting foundations, it would be a great time to take into consideration all of the ways that it could be fundamentally improved, not just notions that may be able to act as a band aid for the short term.

b. Reflection Questions

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

Overall, this article changed my current way of thinking just in the fact that I had always thought of financial accounting principles as concepts that had been around for a long time and would continue to be stagnant. It was very eye-opening for me to see an example of how there is actually still debate in the accounting community about how things should be done and that there are individuals who are very passionate about this change. Up until reading this article, I just assumed that everyone was in agreement that this was the way that we’ve always done things and that we should just keep doing them the same way.

It also opened my eyes to the fact that the FASB is still currently making large changes to the conceptual framework- I had assumed that their main function now was to ensure that all of the rules and regulations that they created concerning financial accounting were followed.

In addition to this, I was also introduced to the idea that there may actually be a better way to present information on financial statements that actually makes this information more pertinent to investors. Before this, I assumed that there was no possible way to change financial statement calculations; I thought that it was done the way we were taught in class and that would be the way that it will always be.

I was also shocked to read that the manner in which financial statements are currently created may actually end up hurting the economy by deteriorating the quality of earnings projections. Prior to this I knew that accounting in general is obviously very important to the business market, but I had no idea that something as seemingly innocent as using the balance-sheet approach over the income-statement approach would have such an immediate impact.

Another way that this article changed my way of thinking was in regard to all of the research that can be done in the field of accounting. Before reading this, I assumed that those with careers in the STEM fields were the only ones who did research, or that the only accounting research that could be done centered around what happened in the past. However, after reading this, it is very evident that there is still much that I can learn about accounting theory and that much of the work that is done surrounding this topic is done in a prospective manner.

ii. **How will you use this information in your future career? Be thoughtful and creative about the situations you will encounter where this article will affect your beliefs and the way you carry out your future job.**

In my future career I can see myself using this information to react to any new changes in financial account standards that may be released. For example, recently both the tax code and the leasing standards have been changed. I think that this new information would help me to look at both of these new standards under both the balance-sheet method and the income statement method- a mindset that could be very valuable to a future employer. This is also a mindset that I will carry forward and apply to any other future changed standards.

Another situation that I may encounter is if there is actually a legitimate discussion about if standards should actually be changed to the income statement method, then I would have a decent amount of knowledge about why this might be a good decision. However, before I voiced my opinion about this subject in front of other professionals, I would want to do some additional research on why using the balance statement method might be a better choice.

In regard to how this article will affect my future beliefs, it made me think that there might always be a better way to do something, even if the way that it is currently being done is regarded as acceptable by a general consensus. In regards to how this will affect the way that I carry out my future job, I think by just being exposed to this material and the concept of accounting theory in general, it will push me to make sure I am informed of all that is going on in the world of accounting standards, as this is an area that will soon directly affect my day-to-day life as an accountant.

It also made me more confident in my accounting knowledge and also made me feel more comfortable discussing accounting with my peers in a more conceptual manner instead of the typical computational conversations that occur. Overall, this case showed me the importance of staying up-to-date on what is happening at a federal level in the industry that you are in, even if the changes that are being made are not yet concrete and may not seem to have a large, immediate impact on your work.

Case Study Twelve

Google Inc. – Earnings Announcements and

Information Environment

i. Introduction

In this case, students were introduced to the idea of non-GAAP financial measures. These are figures companies choose to include in their press releases that are not audited and do not have to follow all GAAP standards. However, for some quality control, companies are required to connect these statements back to another figure that is compliant with GAAP and also have to explain their reasoning in including these non-GAAP measures. As these statements are commonly put out through the lens of the company's management, they are highly valued by investors as they allow them to get a sense of where the company will be going management wise. In this specific case, students were tasked with looking at a press release from tech giant Google and determining how the investment community received this press release as a function of Google's stock price.

Before completing this case, I had seen and read some press releases and understood the general idea of what one was in conjunction with the official financial statements. However, I was very unfamiliar with the concept of non-GAAP financial measures and had never actually seen any real-world examples of them. After completing this case and reading the supplemental article provided by Dr. Dickinson, I have a very firm understanding of what kind of information is used in the calculation of these figures and how they may be used by both the investment community and the company itself.

ii. Case Requirements

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

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

The difference between the GAAP net income and the non-GAAP net income can be traced back to the fact that in calculating the non-GAAP net income, Google chose to exclude expenses that, according to the press release, they find "may not be indicative of [their] recurring core business operating results". These removed expenses include stock-based compensation-expense and its related income tax effects, restructuring and related charges and their related income tax effects, and net loss from discontinued operations. I agree with the deduction of their removal of expenses related to restructuring and net losses from discontinued operations as these fit their definition of not being part of their recurring business operations but, I do not agree with the removal of the stock-based compensation expense as they themselves say earlier in the press release that “SBC has been and will continue to be for the foreseeable future a significant recurring expense in Google’s business.” The fact that it is a recurring expense leads me to believe that this amount should not be removed when calculating non-GAAP net income.

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

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

Both their earnings performance and stock price followed a similar upward trend- as their quarterly reports were released and investors saw that they were doing financially well, they decided it would be beneficial to invest in their stock, thus increasing its price.

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

For the majority of the year, Google’s stock price performance was above the NASDAQ index. However, there were certain instances during the fiscal year in which Google’s stock performance was either right on par with the market or slightly under it. For example, at the beginning of the year, there is a slight dip below the market average, an instance that reoccurs in mid-October.

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

Assuming that the press release was released on the same day as the financial statements, the press release was received as "good news" as after it was released, there was a spike in the stock price.

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

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

Revenues were slightly higher than what analysts predicted, coming in at $16.9 billion instead of the projected $16.8 billion. This amount represents the 17 percent increase in revenue that was seen over the figures from the previous year. This news is consistent with the reaction of the stock market as after Google announced these figures, their share price rose 4 percent.

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

Another factor that might have led to the market's positive reaction is the fact that despite the increase of internet usage on cellphones over desktops, a move that was predicted to lower Google's bottom line, they were still able to increase their profits in the end. However, as the smartphone trend isn't going away any time soon, this still might be an issue in the back of some investor's minds going forward. Also, the announcement that they were going to be selling off Motorola, a division that had been bringing them losses for quite some time, was also a sign to investors that they would continue to thrive as a company for now.

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The Honor Code:
"On my honor, I pledge that I have neither given, received, or witnessed any unauthorized help on this case study analysis."

Signed Brooke Boyle