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A COMPREHENSIVE ANALYSIS OF FINANCIAL REPORTING THROUGH CASE STUDIES

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

Oxford, MS
May 2020

Approved by:

Advisor: Professor Victoria Dickinson

Reader: Dean Mark Wilder

ABSTRACT

SARAH CLANCY: A Comprehensive Analysis of Financial Reporting Through Case Studies
(Under the direction of Doctor Victoria Dickinson)

The Sally McDonnell Barksdale Honors College gives students of the Patterson School of Accountancy the unique opportunity to undergo an alternative thesis process. I completed two classes, one in each semester of my third year, in which I studied technical accounting and financial reporting through case studies. These case studies required that I research multiple aspects of the accounting field, including data analytics, financial statements and other accounting principles. In addition, Dr. Dickinson invited accounting professionals from prominent accounting firms to our class to give honors students the opportunity to learn and network.

I could not be any more grateful for the opportunity to pursue and alternative thesis route. Not only was it beneficial to learn about the principles and theories of accounting in-depth, but the chance to interact with real professionals was invaluable. Dr. Dickinson took the time to schedule Big 4 and regional firms to come present to our class 6 times per semester, and I truly think it increased my likelihood of getting an internship.

I recently returned from a Big 4 audit internship in New York City, where I have accepted a full-time offer upon completion of my Master's degree and CPA. The following review of accounting through case studies is a reflection of my growth and success over the time at the University of Mississippi and as a student of the SMBHC and PSOA.

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Case 1: Data Analytics

Introduction:

This case is about the various data and analytics tools that are in the world of technology today. Many of these tools are used by accounting firms today to sort and visualize hundreds of thousands of items of data. These tools make it easier for firms and businesses to examine the data and make decisions that will help to improve their productivity and efficiency. The purpose of this case was to expose us to what data analytics is because it is becoming more and more prevalent in the accounting world everyday. I learned that, though accounting seems like it consists of many routine processes with very little changes, technology is definitely bringing improvements and enhancements. The features in Google Fusion save an immense amount of time and effort, and catch so many more mistakes than the human eye ever could. This information will impact our future career because simply knowing this fundamental information about the programs will already put us ahead of students elsewhere. Accountants who have some level of expertise in these programs are extremely sought after nowadays, and so it is to our benefit, as young, malleable students, to have a basic knowledge now because we could potentially be thrown into the department of data analytics one day.

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

The purpose of Google Fusion is to go beyond other typical data management technologies and appeal to a wider range of users. Google Fusion was designed with those who are not technologically savvy in mind. The creators wanted to make sure that people with no IT expertise or any prior training in data management are able to use the program. Beyond the ease of use for the average person, another advantage of Google Fusion over other data

management tools is it's easy incorporation of data onto the Internet. All visualizations available on Google Fusion are compatible with the Internet and datasets that are made public on Google Fusion have the chance to show up in Google searches so therefore, the information is accessible to the general public. With the ability to share the data on the Internet, users are also encouraged to share their data with other collaborators. The opportunity for multiple collaborators not only enhances the data due to different opinions and insights, but it also allows others to inspect the data and look for errors.

Google Fusion is useful in making business decisions because it can take hundreds of thousands of pieces of data and transform them into conclusions that are significant and useable for the company, such as the highest performing branches, which departments work most efficiently, which marketing campaigns produced the best responses and can even evaluate trends outside of the company that might affect production or sales. The results of these data conclusions help high-level executives to make any necessary changes in order to reach their goals, whether those goals are to increase business performance and efficiency, lower their costs, or expand their market to a broader target market.

2. **How, specifically, would you use the tool in the following business settings? Create at least two 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. Auditing

Google Fusion is extremely beneficial when it comes to identifying fraud. Employees and auditors cannot manually sift through hundreds of thousands of pieces of data and identify anomalies. However, an executive is able to look at all of their company's data through

visualizations produced by Google Fusion. Google Fusion will take data from the company's general ledgers and transform them into charts and graphs and perhaps even more effective, heat maps. The executive can easily look at these graphics for suspicious activity and unusual trends in the data. Once they have identified these trends, they are able to locate the source of the fraudulent behavior and make an effort to stop it. The heat-mapping tool also helps companies to effectively recognize the likelihood of the risk compared to the impact of potential situations.

Another instance where Google Fusion would be a helpful tool in an auditing department would be during the testing stage of an audit. If an audit team is conducting an audit on a big company and they have to look at the last five or more years of data for this company, it would be nearly impossible to manually go through every piece of data when testing it, which leads to sampling, and potentially overlooking problems and errors within the company. Google Fusion, however, can take these pieces of data and, based on the headers of the row/column and actual data, try to detect what the data is and pinpoint any anomalies. This feature will save auditors a lot of time and also increase their accuracy because they will be able to analyze and test much more data and they could without this data analytics software.

b. Tax Planning

One scenario where Google Fusion would be beneficial from a Tax Planning point of view is with a company who is looking to expand to other nations, but does not want to pay a lot of taxes. Said company could use Google Fusion to apply their financial information to the tax rates of various countries to identify which countries it would be most logical to expand to at the lowest cost. Beyond this, Google Fusion can hold and display data regarding the

requirements for tax reporting in the various companies, which is also something that the company would want to consider when expanding their business.

Google Fusion's collaboration feature would be extremely helpful to a tax-planning department. One of the greatest struggles in Tax is waiting for other people and companies and to provide their information in a timely manner. However, the Tax department has the opportunity to share the Google Fusion with outside clients and companies who can then import their financial information and tax codes from nearly any other format (Excel, Google Spreadsheets, Open Office etc.) directly into the Google Fusion table. This saves time not only from the actual transfer of the information between the companies but also the Tax department does not need to manually insert the data, as it can be uploaded straight from the original format.

3. **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.**

Good morning Sir,

I have spent the past week researching a data analytics program called Google Fusion and I think our firm should consider investing in and utilizing this tool. First and foremost, this program is free, so we would not have to pay any installation fees. Also, it is designed for the average person to use, so no background or expertise in technology or data analytics is necessary and moreover, we would not have to pay for our employees to be trained in it. Beyond the economic benefits, however, this program would be beneficial to both our audit and tax departments. It would be extremely helpful in making future business decisions and helping to detect fraudulent activity with it's advanced visualization and heat-mapping

tools. It also has a collaboration feature so that our clients can import their financial statements into our documents, which would be a significant time-saver. Overall, my assessment of this program leads me to believe that we should test it out, and considering there is no cost to us, there really is no reason that we should not give it a try.

Best,

Sarah

Case 2: Creation and Analysis of Financial Statements

Concept 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?

Given the size and extensive nature of this company, I expected to see not only high numbers in the cash and accounts receivable accounts, but also in the Property, Plant and Equipment account. As for major liabilities, I expected accounts payable and accrued salaries and wages. Finally, based on the desctiption of the company, I was expecting to see revenue accounts beyond sales, such as franchise fees and royalties and sales to franchises, both of which I have never seen a company's financial statements before.

Summary and What I Learned

This case mainly consisted of creating financial statements for a company after analyzing transactions and then adjusting and closing the necessary accounts. This case was very beneficial for this particular week because it is tying in nicely with what we are learning/reviewing in intermediate accounting and finance. This case helped me to see the relationship between the journal, income statement and balance sheet of a company. Also, looking at the accounts of real-life company helped me to realize that there are accounts that I have never considered to have an effect on a company before, like royalties and franchise fees. Finally, it forced me to familiarize myself with some aspects of Excel that I never have before, like referencing cells and repeating a column so that it will print on multiple pages.

Table 2-1 Trial Balance

		Beginning Balance	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 Receivable	$ 4,229,733.00			$ 5,000,000.00		$ (4,100,000.00)						$ (702,207.00)	$ 4,427,526.00
	Notes Receivables, 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, Current	$ 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 Receivables, 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, Long Term	$ 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)					$ -
	Other Accrued Expenses	$ 531,941.00						$ 3,300,000.00					$ (2,885,413.00)	$ 946,528.00
	Dividend Payable	$ 598,986.00										$ 3,709.00	$ (1.00)	$ 602,694.00
	Deferred Income	$ 142,000.00								$ 125,000.00			$ (46,062.00)	$ 220,938.00
	Deffered 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 of 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 & 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
	A=L+OE+R-E	$ -	$ -	$ -	$ -	$ -		$ -	$ -	$ -	$ -	$ -	$ -	$ -

Unadjusted Trial Balance	12. Adjust for inventory count	13. Record depreciation	14. Wage accrual	15. Consultant's Report	Pre-Closing Trial Balance	16. Closing Entry	Post-Closing 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)	$ -	$ -
$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -

Table 2-2 Rocky Mountain Income Statement

Rocky Mountain Chocolate Factory, Inc. Income Statement For period ending December 31, 2010		
Revenues		
Sales	$	22,944,017.00
Franchise and Royalty Fees	$	5,492,531.00
Total Revenues	$	28,436,548.00
Costs and Expenses		
Costs of Sales	$	14,910,622.00
Franchise Costs	$	1,499,477.00
Sales and Marketing	$	1,505,431.00
General and Administrative	$	2,422,147.00
Retail Operating	$	1,756,956.00
Depreciation and Amortization	$	698,580.00
Total Costs and Expenses	$	22,793,213.00
Operating Income	$	5,643,335.00
Other Income (Expense)		
Interest Expense	$	-
Interest Income	$	(27,210.00)
Other Total	$	(27,210.00)
Income Before Income Taxes	**$**	**5,670,545.00**
Interest Tax Expense	$	2,090,468.00
Net Income	**$**	**3,580,077.00**
Common Share Outstanding		6,012,717
Earnings Per Share	$	0.60

Table 2-3 Rocky Mountain Balance Sheet

Rocky Mountain Chocolate Factory, Inc. Balance Sheet As of December 31, 2010					
Assets			**Liabilities**		
Current Assets			**Current Liabilities**		
Cash and Cash Equivalents	$	3,743,092.00	Accounts Payable	$	877,832.00
Accounts Recievable	$	4,427,526.00	Accrued Salaries and Wages	$	646,156.00
Notes Receivable, Current	$	91,059.00	Other Accrued Ecpenses	$	946,528.00
Inventories	$	3,281,447.00	Dividends Payable	$	602,694.00
Deferred Income Taxes	$	461,249.00	Deferred Income	$	220,938.00
Other	$	220,163.00	**Total Current Liabilities**	$	3,294,148.00
Total Current Assets	$	12,224,536.00			
			Deferred Income Taxes	$	894,429.00
Property and Equipment, Net	$	5,186,709.00			
			Total Liabilities	$	4,188,577.00
Other Assets					
Notes Receivable, Less Current Portion	$	263,650.00	**Stockholders' Equity**		
Goodwill, net	$	1,046,944.00	Common Stock	$	180,808.00
Intangible assets, net	$	110,025.00	Additional Paid-In Capital	$	7,626,602.00
Other	$	88,050.00	Retained Earnings	$	6,923,927.00
Total Other Assets	$	1,508,669.00	**Total Stockholders' Equity**	$	14,731,337.00
Total Assets	$	18,919,914.00	**Total Liabilities and Stockholders' Equity**	$	18,919,914.00

Table 2-4 SCF Transaction Classification

Transaction Number	Section of Cash Flow Statement
1	Operating
2	Operating
3	Operating
4	Operating
5	Operating
6	Operating
7	Operating
8	Operating
9	Operating
10	Financing
11	Operating
12	Operating
13	Investing
14	Operating
15	No Entry

Case 3: Scenario Reflection

Introduction:

For this case, our class performed three "skits" demonstrating different scenarios that come up often when accounting students are interviewing for, or doing their internships. The class then divided itself into two groups of people: those who thought the student in question was in the right and those who thought they were in the wrong. It was very interesting to see where people came from when choosing a side and to listen to their points of view. However, what I found even more interesting was that not one person changed their mind, even after listening to the other side's point of view. Some of the arguments got a little heated and I think some people may have taken things a little too personally, but after everything was discussed, I think the one thing that the whole class can agree on is that it is imperative to be honest and transparent with the firm for the entire duration of the internship process.

Scenario #1:

Scenario #1 revolved around a student who was going through the accounting program here at Ole Miss, and was intending on going through the internship process even though he was planning on going to law school to pursue tax law. I think that the student wanting to get an internship and still go to law school has a legitimate point. Perhaps he should have a better reason to go to law school than making more money than accountants, however it is his life and if money is what dictates his future, than so be it. Also, this student was completely in the right when he said that an internship with a Big 4 firm would look great on his resume and would help him get into a better law school. Also, an internship at a Big 4 could still be a way to get his foot in the door because Big 4 firms hire lawyers too.

Finally, though the scenario never mentioned the option of pursuing a dual-degree program, it would be a great opportunity that would maximize the student's future options.

As someone who is considering law school myself, this scenario was very eye opening for me. I realized that, in order to be fair to the firms, I need to be completely transparent with them from the beginning. Also, I will stick by my decision that this world is dog-eat-dog. I do not think that anyone should ever take a step to the side for someone else's benefit. I work hard for my own accomplishments and to be quite frank, I would not feel proud or justified if I got something because someone else decided that they "did not want to take something from someone else."

Scenario #2:

This scenario was similar to Scenario #1 in the sense that it was about students who wanted to major in accounting and pursue a career other than an accountant, but still wanted to get an internship at a Big 4 firm. Again, like the last scenario, I believe that the students wanting to go into consulting and investment banking completely had the right to both get a degree in accounting and intern with a Big 4 firm. One student even mentioned that a recruiter at a firm told her to still intern with them as a way for her to find clarity and help her to decide which she liked better.

Again, I think the underlying message in this scenario is that transparency is key. It is completely fair and valid that students should want to keep their options open, get their foot in the door wherever they can, and do what benefits them and their future.

Scenario #3:

In this scenario, a former student and graduate assistant of Dr. Dickinson decided that they wanted to move back to their hometown of Dallas after they interned in

Washington D.C. Once again, I am in agreement with the student and think it was fair that they changed their mind. I am only 19 years old, and the human brain does not fully develop until 25 years old. I have no idea what will change for me in one year never mind three years or five years, and to ask someone so young to decide their future and set it in stone is unfair. However, this is not to say that I think that a student should choose a city because it would be fun to live there for three months when they know full well that they intend to get a full time job in another city.

Speaking personally, coming to Mississippi from Boston was a gigantic risk and thank God it worked out for me because I love it here. On the other hand, though, life is too short, and had I been miserable during my first semester, there is no way I would have spent years trying to force myself to like it, nor should anyone have to go through that, whether it be in college, internships, or jobs. It isn't worth someone's mental health to force him or her to stay somewhere where they do not have friends, and they should not feel bad for wanting to go somewhere they can happy.

Finally, I understand that the firms in all of the different cities are separate to a point, but one of the perks of working at a Big 4 is that they are multinational and have offices all over. I have to believe that for one Ole Miss student who wants to go home to Dallas from Washington D.C., there is a Boston College student who wants to leave the Boston office and go to Washington D.C. and a UT Austin student who wants to go from Dallas to Boston. I could be completely off base, but something tells me that Ole Miss students are not the only one who change their mind, and that everything eventually evens itself out.

Case 4: Security Sales

Introduction:

This case is about the sales of debt securities and the potential impairment losses that come occur as a result of the sale. An impairment loss occurs when a debt security is sold when it's fair value amount is less than it's amortized cost. This case involved a lot of examination and reading of external sources like the FASB Codification, the FDIC, OCC, etc. This case was more difficult than others because we really have not learned about any of the components that were included. Also, the external sources were extensive and detailed, which made it tedious to look through and find exactly what was necessary to answer the question that was asked.

This case was more difficult than others because we really have not learned about any of the components that were included. Also, the external sources were extensive and detailed, which made it tedious to look through and find exactly what was necessary to answer the question that was asked. Honestly, reading through this case the first few times could be equated to reading a foreign language. After reading and re-reading the material, there was slight improvement in my understanding of it, but I still feel far from comfortable with the material. I think it would be interesting to return to this case some time in the future, perhaps when we have learned about it more in class, or even if I had more than just a few days to review it. I would like to see whether I would have the same answers with a better understanding of the material as I do now.

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

Assuming Generic Bank sells the aforementioned securities in early 20x3, they will have an impairment loss on the seven securities designated above (003, 015, 025, 030, 067, 076, and 096). As stated in the case, "under ASC 326-30, the bank is responsible to determine if securities in unrealized loss positions are impaired" The determinations include deciding whether the decline in value of debt securities are due to credit losses or due to fluctuations market activity. These seven securities meet both requirements, meaning that 1) the decrease in value of the securities is due to a decrease in market activity (change in interest rate) and 2) Generic Bank does not want to / is not able hold onto these securities because the Bank does not want impairment losses because they want to avoid a negative impact on income.

All but two of these securities have an impairment loss. These two securities without a loss are 067, which has a fair value $16,338,000 greater than the amortized cost, and 096, which has a fair value $7,867,000 greater than the amortized cost. The total sum of the impaired loss of the other five securities (003, 015, 025, 030, and 076) is $78,414,000.

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

Generic Bank would not have an impairment loss on securities other than the seven securities sold because they are only selling those seven securities, which implies that they are keeping the other ninety-three. Losses can only occur when securities are sold, so while the securities portfolio for Generic Bank would still be in a net loss position, it would not be possible for there to be impairment losses on those ninety-three securities because they were not sold. Because there would be no impairment loss, there technically is no reason to determine the extent of the impairment. However, should the Generic Bank decide to sell the remaining securities in the future, they would determine the extent of the impairment loss by subtracting the fair value from the amortized cost for each security and adding all of those values together.

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?

As the case says, an external auditor would likely examine the cause of the declines in values of the securities with more skepticism. However, assuming that Heather Herring analyzed the securities and found that the declines in the values of the securities were indeed due to changes in interest rates and not credit deterioration, the answer would not change, and Generic Bank would still have an impairment loss.

The same is the case with a bank regulator. They would go into even more depth than an external auditor would, and assuming that again, the declines in security were not due to decreases in credit, the answer would not change.

An external auditor or regulator would consider many other factors when making their determination. According to the Federal Reserve, "if an institution's process for assessing impairment is considered acceptable, examiners may use those assessments in determining the appropriate classification of declines in fair value below amortized cost on individual debt securities." They would first look into Generic Bank's process for evaluating the impairment. They would research the terms of every bond to ensure that they actually do not allow the securities to be settled at a value less than the amortized cost. If this assertion is not made in every bond, then it is completely possible that the declines in value could be due to credit deterioration. If this were the case, Generic Bank would not be able to /intend to hold onto any of the securities until the value because the value would not ever go back up.

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

If the securities sold had been collectively in a net gain position, the assessment of the existence of an impairment in requirements 1 and 2 would change because, while even if some of the securities sold had fair values that were less than the amortized cost, and thus individually suffered an impairment loss, a net gain position implies that there total amount of the amortized cost of the securities sold was less than the fair value. Therefore, overall, there would be no impairment loss for the Bank.

If all securities sold were in gain positions, than the assessment of the existence of an impairment in requirements 1 and 2 would change. If every single security sold were in gain positions, this means that the fair value was greater than the amortized cost of each of

the securities. Therefore, it is not possible that any of the securities sold had an impairment loss.

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?

Yes, Generic Bank does have an impairment loss on securities other than the seven securities sold. Because the bank is only adequately capitalized, and not well capitalized, they are less likely to be able to hold onto the securities to wait for them to increase in value. This means that they will have to sell more securities in order to get cash, and because their securities folder is at a net loss position right now, it is likely that the additional securities sold will be at a loss, thus causing an impairment loss.

Footnote 5 states: “The FHLB advances funds to meet banks’ liquidity needs. The amount and structure of advances are based on the financial health of the bank ... Thus, these funds would likely be available to Generic Bank as it is well capitalized.” The FHLB provides funds to banks that are well capitalized, but Generic bank is only adequately capitalized. The other sources of liquidity, such as that from the FHLB have been helpful to Generic Bank in receiving additional cash, and likelihood that they will still provide additional funds to an adequately capitalized bank, as opposed to a well- capitalized bank is slim. The lack of additional funds from outside sources is now another reason that Generic Bank will have to sell additional securities, which will likely cause an impairment loss.

Case 5: City Selection

Introduction

The purpose of this case is to have us, as prospective interns, sit down and think long and hard about our future. We have to officially choose our cities within the next few months and speaking personally, I push that thought to the back of my brain because it is scary and stressful. This case will help us to think in advance and start to narrow down our options for location preference. It is likely that this case may even cause an epiphany for some students, which would be outstanding not only for them, but also for the firms who want to avoid flaky students at all costs.

I have chosen to compare New York City and Chicago. I know it will be interesting to see what I find in my research for each city because while they are different in a lot of ways, they are also very similar. Also, they both closely resemble Boston, which is where I grew up and love. Because of this, I feel like my ultimate decision will be wherever feels most like home.

Findings

1. The population of New York City is 8.623 million people. The population of Chicago is 2.716 million people. Growing up just outside of Boston, I have always loved big cities and the excitement that exists in them. I love that there is always something to do and always new people to meet. I cannot imagine living more than an hour from a major city, so I feel that in this respect, both cities would be a great fit for me.
2. The climate and seasonal fluctuations in New York and Chicago are fairly similar because they are both in the Northern part of the country. Of course, Chicago is the "Windy City", so they are more affected by wind, and New York is right on the Atlantic Ocean, so their weather is affected by that, but both cities truly experience all four

seasons. I grew up with orange autumns and white Christmas', two things that these cities have and that I really miss when I am Mississippi.

3. Because both Chicago and New York are such large cities, neither of them really have many geological features. However, both have places within the rustle and bustle of the city that feel separated. Within the concrete jungle that is New York, there is Central Park. Central Park is one of my favorite places ever. I love to people watch, so getting to see everyone from a businessman on his lunch to a fourth class on a field trip is so enticing to me. Also, as I mentioned in Finding 2, I love cities that experience all seasons, and Central Park is the only place in New York City that would actually see the seasons, opposed to just feeling the change in weather.

Similar to Central Park in New York, there is Millennium Park in Chicago. Although I have only been to Chicago once in my life, I can still remember how impressed I was with the "Bean." Also, just like in Central Park, there are all kinds of people roaming around in Millennium Park, so I would love to spend an hour or two in either place with a book and a coffee and just people-watch and relax. What sets Chicago apart from New York in terms of scenery is that it is right on Lake Michigan, which is far more beautiful than the Atlantic Ocean. I struggle with the idea of being land-locked, but knowing I have Lake Michigan so close-by makes the thought more bearable.

4.

Table 5-1	New York City	Chicago
Federal Taxes	10.42%	10.42%
State Taxes	4.69%	3.59%
Local Taxes	0.00%	0.00%
Total Taxes	15.12%	14.01%
FICA	7.65%	7.65%
Take Home Semi-Monthly Salary	$1,609	$1,632

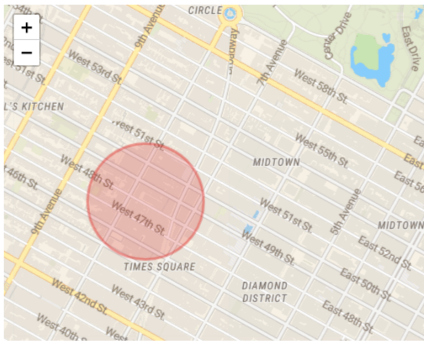
The differences between the tax deductions of the two cities are fairly immaterial. I have just accepted that taxes are going to have a sad and unfortunate affect on any city or state, and it is just something that has to be lived with.

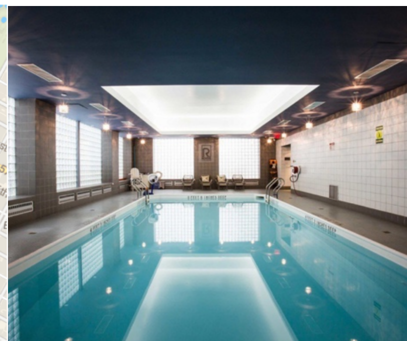
5. Chicago's means of transportation include the "L" rapid transit, buses and two major airports, O'Hare and Midway. New York's means of transportation includes the subway, buses, and major airports of JFK, LaGuardia, and Newark. There does not seem to be a need for a car in either city, which is definitely a pro. Also both cities have pretty easy ways to get home to Boston, with direct flights from all airports, and from New York, the Greyhound Bus Line.
6. New York, being the size that it is, has companies in almost every industry, but its most prominent industry would definitely be financial services. Chicago, on the other hand specializes in manufacturing, specifically food, and also in transportation and information technology. New York's versatility definitely puts it ahead of Chicago in this case, because not only do I have very little interest in Chicago's top industries, but also the ability to switch up client-types every few rotations is very appealing. Also,

becoming familiar in financial service companies would be a great perk in case I decide to leave Public Accounting at some point.

7. Northwestern Memorial Hospital, Rush University Medical Center, and Loyola University Medical Center in Chicago are all nationally ranked for Adult Specialties, as are New York-Presbyterian Hospital, NYU Langone Hospitals, and Mount Sinai Hospital in New York. Thankfully, I have no sever illnesses that would require me to go see a doctor more frequently than once a year, but even so, I do not think it would be hard to find a good doctor in either city.
8. Murder, rape and robbery are the most common crimes in both Chicago and New York. The most dangerous neighborhoods in Chicago (based on most murders per 100 thousand people) are West Garfield Park, North Lawndale, and Englewood. The most dangerous neighborhoods in New York (based on crime rate per capita) are Vinegar Hill (Brooklyn), Downtown Brooklyn, and the Meatpacking District (Manhattan). I have been to New York many times and have never felt unsafe. Also, crime rates have been consistently decreasing in New York since the 1950's. I cannot say the same for Chicago, when the only time I have ever been, my family and I were walking through a bad part of town after a White Sox game and we were all scared and felt unsafe.
9. In New York City, I would expect to pay somewhere around $2000 per month. I would want roommates no matter where I lived, not only for financial purposes, but also because I would be lonely without people to hangout with all the time. The following photos show a 3-bedroom, 2-bathroom apartment in the Theater District of Midtown Manhattan. This apartment is even more luxurious than something I would need at the

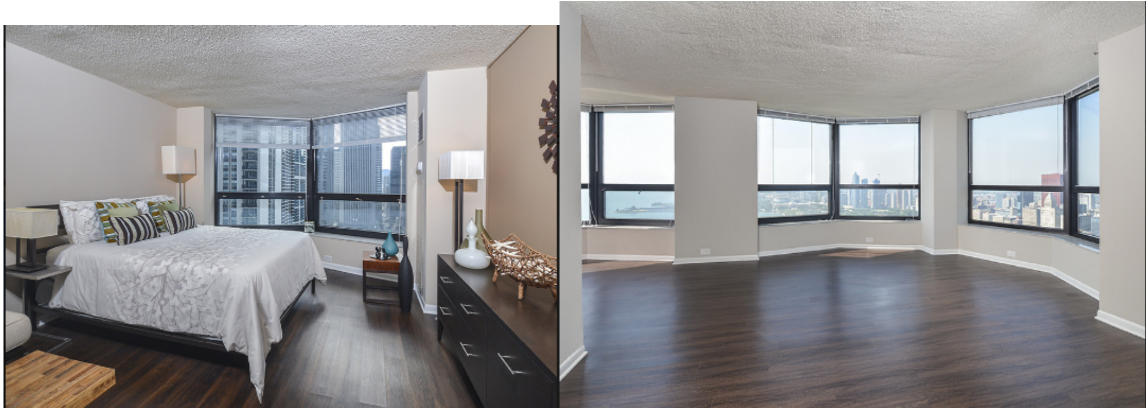
time, especially since it includes a lot of amenities and my monthly rent would be $1,956.



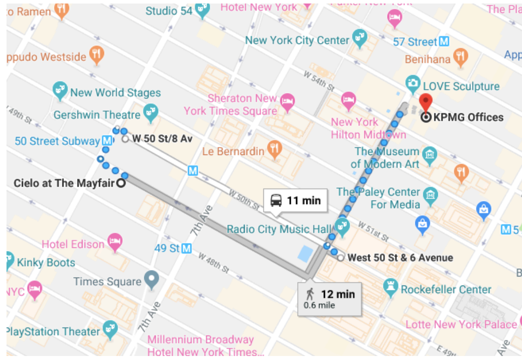


In Chicago, I would expect to pay between $1,400 and $1,800. Again, I would want roommates, so that would definitely help support the cost of rent. The following apartment is a 3-bedroom, 2-bathroom apartment in the New East Side neighborhood of Chicago.

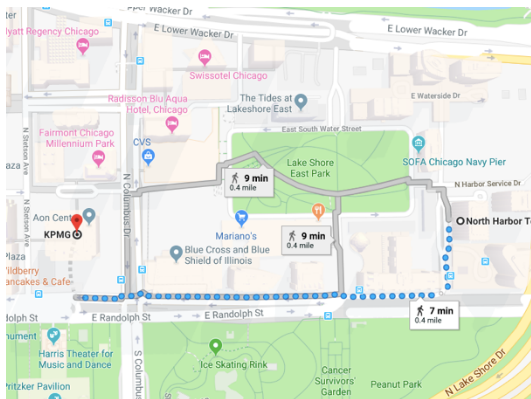
Like the New York sample apartment, this apartment is more luxurious than anything I would need, especially because I would expect to spend most of my time at the office.



10. From the apartment in New York shown above, the commute would likely be between 10-15 minutes (walking), assuming that my firm is in Downtown (using the KPMG Chicago office as an example).



From the apartment in Chicago, the commute would likely be a 10 minute walk (using the KPMG Chicago office as an example).



11. In my first year working, I would probably plan to buy my weekly groceries from Amazon Fresh or some other online grocery ordering and delivery service. This is primarily because I would be spending the majority of my time at the office and I am making the presumption that many lunches and dinners would be provided on those late nights. Also, I do not eat breakfast anyway, so I would really only need to buy myself snacks and enough for two or three dinners every week.
12. When it comes to laundry, I would ideally live in an apartment building that has washers and dryers in it. If I am not so fortunate, I will have to find a nearby Laundromat, or make friends with people who live close-by who have washers and dryers in their building.

13. One organization I would definitely become an active member in no matter what city I live in is Alpha Omicron Pi Alumnae (Chicago City or NY/NJ Metro Alumnae). I would also hopefully find a Greek Orthodox Church in either city that is close to where I live, or is easily accessible with public transportation. Finally, I would like to spend sometime volunteering in a hospital in whichever city I end up in. Specifically, the Morgan Stanley Children's Hospital in NYC has a position for a volunteer in the Pediatric Emergency Department where I would comfort and distract people waiting in in the waiting room for their family. This is something that I would really love doing, even if I could only do it once in a while, because it would be so impactful to take a family's mind off of the stress and sadness that they are facing.
14. I love any and all sports so I would like to get season tickets to one or two sports teams in either city I live in. I could never cheer on the Yankees, so in New York, I would go to Mets' games, Islanders games, Giants' games (for some Ole Miss Alum), and Knicks' games. Beyond sports, I love the Metropolitan Museum of Art and would love to get a seasonal pass there. I also have gone to multiple Broadway shows and would continue to treat myself to those every once in a while. Finally, Madison Square Garden hosts over 200 performances a year, so I am confident that there will always be some kind of show I want to see.

    The activities I would engage in in Chicago are similar to those in New York, but they are on a slightly smaller scale. I can see myself becoming a die-hard Cubs fan, second only to the Red Sox, and love Wrigley Field, so I would definitely want season tickets. I would also try to catch some Blackhawks games and maybe the occasional Bears' game. I am sure that traveling casts of Broadway productions come to Chicago rather

frequently, just as they do Boston, so I would always have the opportunity to catch a show when I want. Finally, I love Navy Pier and Millennium Park, and can see myself running or walking in those places everyday.

15. As I said earlier, both cities provide fairly easy access home. New York would definitely be the faster and cheaper option of the two. Flights from New York to Boston average 1 hour long and are less than $200. There is also the option to take the Greyhound Bus from New York to Boston, which I have done multiple times for only $12 each way, or the Amtrak train for about $50 each way.

    While a flight is the only realistic way to get from Chicago to Boston, nonstop flights are only 2 hours long and can cost as low as $140.

16. Table 5-2

<u>New York Budget</u>		<u>Chicago Budget</u>	
Total income for year	$ 60,000.00	Total income for year	$ 60,000.00
(Taxes)	$ 8,328.10	(Taxes)	$ 7,716.71
Net pay	**$ 51,671.90**	**Net pay**	**$ 52,283.29**
Monthly income	**$ 4,305.99**	**Monthly income**	**$ 4,356.94**
Rent	$ (2,000.00)	Rent	$ (1,600.00)
Groceries	$ (150.00)	Groceries	$ (150.00)
Dog Payments	$ (200.00)	Dog Payments	$ (200.00)
Phone	$ (50.00)	Phone	$ (50.00)
Total	**$ (2,400.00)**	**Total**	**$ (2,000.00)**
Savings/ investments	$ (750.00)	Savings/ investments	$ (1,000.00)
401k	$ (250.00)	401k	$ (350.00)
Total	**$ (1,000.00)**	**Total**	**$ (1,350.00)**
Exercise	$ (50.00)	Exercise	$ (50.00)
Entertainment	$ (150.00)	Entertainment	$ (200.00)
Shopping	$ (150.00)	Shopping	$ (200.00)
Restaurants	$ (300.00)	Restaurants	$ (300.00)
Travel (home or to friends)	$ (250.00)	Travel (home or to friends)	$ (250.00)
Total	**$ (900.00)**	**Total**	**$ (1,000.00)**

17. and Conclusion

Based on my full analysis of both cities, I would still be more than willing and happy to live in either city. I feel like the biggest difference between the two is the size. While the size of Chicago is probably a better fit for my personality, my familiarity and comfort level with New York makes up for it. Both cities will require me to budget my money well because they are expensive, but the experiences in each are unmatched and make it worth it. Both cities have all four major sports teams, and because I grew up supporting celebrating all of Boston sports, big fan bases are very important to me. There are so many opportunities available in both cities, and I know I will grow as both a person and a professional in whichever one I end up in post-graduation.

I really enjoyed the ideas and reasoning behind this case, but unfortunately it was not very helpful for me. While in reality it is probably good that I am considering two cities that are very similar to one another, it made comparing the two rather difficult in this context. I am naturally an indecisive person, so I have a feeling my city preference will end up being a game-time decision before my interviews. That being said, I have always been a planner, so this case was fun for me. I loved making a budget and exploring the different housing options. In a time that is very stressful for us, this case brought some excitement and helped me to look at the bright future ahead that I so often forget about.

Case 6: WorldCom, Inc. – Capitalized Costs and Earnings Quality

Introduction:

The purpose of the case is to delve deeper into the WorldCom fraud scandal. While at this point we all have at least a basic understanding of what occurred at WorldCom in the early 2000s and the results, this was the first time I learned the accounting logistics background. In this case, we look into WorldCom's financial statements and evaluate what capitalized costs are, and then their affect on the company's financial statement.

In intermediate accounting, we are currently learning to differentiate between costs that should be expensed and those who should be capitalized. However, I have never had the best understanding of the difference. Beyond that, I never knew the grave affects that improper capitalization could have on a company. In the case of WorldCom, this fraudulent mishap was one of the factors that led to the demise of the company.

Concepts:

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

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

   SCON 6 defines assets as something that the company owns or controls that will eventually provide them economic benefit in the future (directly or indirectly).

   SCON 6 defines an expense as a cost to the company that eventually provides them with an asset (or benefit). An expense is also when a company uses up their assets.

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

   Generally, costs are expensed as incurred when they expenses expire or when it is predicted that they will not provide any (measureable) future benefit for the company.

Costs should be capitalized when the expenses have not yet expired. This would imply that they would be providing some economic benefit for the company in the future.

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

After their initial capitalization, the costs will be amortized/expensed as the costs are incurred for the rest of the asset's life, this could be a short-term life, like Prepaid Rent, or long-term with the construction of a building. The following are affected when a company capitalizes a cost:

- Income Statement (Net Income): Net Income tends to be larger when costs are capitalized because there are no expenses reported on the income statement.
- Balance Sheet: Capitalizing costs affects both assets and equity on the balance sheet. Assets tend to be greater when costs are capitalized because they are not recorded less of the expense amount. Equity will be greater because net income will be greater, due to the lack of expenses, and therefore, the retained earnings will be greater.

Process:

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

World Com reported $14,739 million in "line costs" in 2001. The "line costs" are fees paid to telecommunications companies by WorldCom for access to networks. The "line costs" have to be expensed and not capitalized.

Entry:	Dr. Line Costs	14,739,000,000	
	Cr. Cash or Payable		14,739,000,000

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 *Wall Street Journal* article refers to the line costs as "one of the long-distance company's biggest expenses: charges paid to local telephone networks to complete calls." These line costs were improperly capitalized at WorldCom. These costs do not relate to assets, as they do not provide any future economic benefit for the company, so they should have been expensed.

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?

Entry: Dr. PPE (Assets) 3,055,000,000

Cr. Line Costs 3,055,000,000

Theses costs appear in the PPE area of the balance sheet and as depreciation expense on the statement of cash flows.

Analysis:

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

Table 6-1

Improper Amount Capitalized	Depreciation Length (yr)	Number of Quarters	Total
$771,000,000	÷ 22	x 4/4 (1)	= $35,045,455
$610,000,000	÷ 22	x ¾ (.75)	= $20,795,455
$743,000,000	÷ 22	x 2/4 (.50)	= $16,886,364
$931,000,000	÷ 22	x ¼ (.25)	= $10,579,546
			= $83,306,820

Entry: Dr. Depreciation Expense 83,306,820

Cr. Accumulated Depreciation 83,306,820

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?

Income Before Taxes (reported)	$2,393,000,000.00
Depreciation	$83,306,820.00
Improperly Capitalized Line Costs	$(3,055,000,000.00)
Loss Before Taxes, adjusted	$(578,693,180.00)
Income Tax Benefit (35% of Loss)	$202,542,613.00
Minority Interest	$35,000,000.00
Net Loss, adjusted	**$(341,150,567.00)**

This difference is definitely material as WorldCom reported their Net Income as a positive $1,501 billion, which is over $1.8 billion greater than the actual loss they experienced that year.

Case 7: Starbucks Corporation – Understanding Financial Statements

Introduction:

The purpose of this case was to become familiar with financial statements and what they represent for a company. We often look and analyze different segments of financial statements in our classes, but we very seldom have the opportunity to look at not only one statement with complete information, never mind in this case where we got to look at three or four related financial statements. Although this case mostly has us looking at each statement, it was still nice to be able to compare and relate information from one statement to the next. This case wasn't necessarily the hardest one we have done, but because of the size and complexity of Starbucks' business, there were definitely some added difficulties.

Concepts:

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

Starbucks makes money through the sale of coffee and tea, along with other foods and beverages in their many restaurant locations. In these restaurants, they also sell retail products that relate to their business, such as coffee mugs, etc. Starbucks also sells its products in supermarkets, hotels, and other businesses to which the company sells its licensed trademarks.

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 for external reporting purposes include the Statement of Cash Flows, the Balance Sheet, the Income Statement and the Statement of Stockholders' Equity. Starbucks refers to these financial statements as "Consolidated". "Consolidated" means condensed, or that the financial statements show only the necessary and relevant totals, and not the intricate details.

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

Publicly traded corporations typically prepare financial statements for external reporting purposes every quarter, which is called a 10-Q. Then, at the end of the corporation's fiscal year, they release a cumulative 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.**

The directors and managers of a corporation are responsible for financial statements. This is in order to ensure that the information is faithfully represented and reliable and if it is not, the upper management is responsible for the repercussions. External users who would likely care about Starbucks' financial statements include investors and creditors. Investors, particularly shareholders, want to be sure that they are making a smart investment and that they will receive returns, so they pay specific attention to the income statement and earnings per share. Creditors are more concerned about whether Starbucks will have enough liquid assets to repay their debts, as they are due.

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's external auditors are Deloitte & Touche LLP. The first "opinion" letter that they provide to Starbucks describes that they have audited the financial statements from Fiscal Year ending September 29, 2013. The letter continues to describe what the audit entails and finally ends with their opinion, which was that Starbucks' financial statements are presented fairly and appear to be in conformity with GAAP. This means that their finances look good and there doesn't appear to be anything fraudulent. Deloitte's second "opinion" letter states that they believe Starbucks has good internal controls. This means that Starbucks has followed the appropriate procedures in their

company so that they were able to produce fair financial statements. These opinions were dated several months after Starbucks' year-end because Deloitte needed time to review and check the financial statements after they were completed.

Analysis:

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

See Statement of Earnings sheet in attached Excel document.

g. Balance Sheet Analysis

i. Demonstrate that the accounting equation holds for Starbucks.

The accounting equation, which is "Assets = Liabilities + Equity", holds for Starbucks. This can be seen on the Balance Sheet in the attached Excel document. When finding the proportions of each account of total assets, it made apparent that Total Liabilities and Equity are 100% of Total Assets, which therefore makes them equal.

ii. What are Starbucks' major assets? Calculate the proportion of short-term and long-term assets for 13. Does this seem appropriate for a company such as Starbucks?

Starbucks' major assets in 2013 are cash, property, plant and equipment, inventories, deferred income taxes, and goodwill. Current assets make up 47.51% of total assets, whereas long-term are 52.49%. These proportions seem appropriate for a company of Starbucks' line of business. They make their money through the sale and distributions of their inventories, and their many retail locations can be sighted as the reason for their high PPE. It should be noted, however, that their proportion of cash and cash equivalents is unusually large, and this amount doubled from 2012.

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

In general, intangible assets are non-physical assets, some of which can have indefinite lives. Goodwill result when a company acquires another company. Starbucks would likely have patents, goodwill, copyrights, franchises, trademarks, and trade secrets. In the description of their business, they explicitly state, "We also sell a variety of coffee and tea products and license our trademarks through other channels such as licensed stores, grocery and national foodservice accounts."

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

Starbucks is financed primarily through equity as opposed to the option of financing through long-term debt. The proportion of long-term debt to total debt and equity is 11.28%, whereas the proportion of shareholders' equity to the total debt and equity is 38.90%.

h. **Income Statement Analysis**

i. **Does Starbucks record revenue when they receive cash from customers or do they follow a different rubric? 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?**

"Company-operated stores revenues are recognized when payment is tendered at the point of sale." "Sales of coffee, tea and related products are generally recognized upon shipment to licensees." "Sales of coffee, tea, ready-to-drink beverages and related products to grocery and warehouse club stores are generally recognized when received by the customer." Based on the previous statements it appears that Starbucks primarily follows an accrual basis of revenue recognition. In this case, revenue is recognized before the cash payment is received. "Revenues from our stored value cards, primarily Starbucks Cards, are recognized when redeemed or when the likelihood of redemption, based on historical experience, is deemed to be remote."

One challenge in measuring revenue is the lack of stability. Every kind of sale follows a different timeline for when to recognize revenue. Also, the store-valued cards have no expiration, so the unearned revenue that is outstanding with those is also a challenge. Due to the size and stature of Starbucks as a company, it would be very difficult to make every revenue receipt on the same timeline, especially across many different vessels (individual stores, grocery stores, etc.), so at this time it doesn't appear that there are any significant changes management can make.

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

Starbucks' two most major expenses are the "cost of sales including occupancy costs" and "store operating expenses." These expenses consist of cost of goods sold and also the money spent to run the stores, such as rent and utilities, etc.

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

Yes, Starbucks made one major change to how they accounted for and reported certain indirect overhead costs. Indirect merchandising, manufacturing and shared service costs were previously allocated to costs of sales and operating expenses, but were removed from that. Also, in 2013, Starbucks added a litigation charge to 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?**

This company likely created a separate line item for this charge so that the general and administrative expense account was not outrageously large in comparison to other years. Also, this is a charge that is important for external users and auditors to be aware of, so placing it separately draws more attention to it. This litigation charge is an operating expense because operating expenses consists of money that the

company pays in order to stay in business, but isn't necessarily related to the primary purpose of the organization, and this litigation charge was money spent to cover court fees, etc. which is not a primary focus of the business.

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

My definition of "profitable" is that net earnings during the year are positive (so not a net loss). Therefore, Starbucks was profitable in both 2013 and 2012. However, Starbucks was significantly more profitable in 2012 than in 2013. This is likely due to the additional litigation charge that Starbucks had in 2013.

i. **Statement of Cash Flows Analysis**

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

Starbucks' net earnings for 2013 is $8.80 million while its net cash provided by operating activities is $2,908.30 million. The difference between these two amounts are attributable to the fact that net cash provided by operating activities is the sum of net earnings, adjustments for non-cash expenses and changes in assets and liabilities.

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

Starbucks paid $1,151.20 million for additions to property, plant and equipment during FY 2013.

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?**

Starbucks paid out $628.90 million for dividends during the year. This amount is greater than the amount of dividends listed on the statement of equity (which is $543.70 million). The difference in these amounts is probably due to the difference in declaration and distribution of the dividends, so Starbucks paid out more dividends than they declared.

j. Several notes to 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?

Estimated accounts include: goodwill, stock-based compensation forfeiture rates, PPE (depreciation and useful life), future asset retirement obligations, inventory reserves, certificates of deposits and the fair value of long-term debt. Some accounts that likely would be estimate-free would be deferred income taxes, cash and cash equivalents, and the accrued litigation charges.

Table 7-1 Consolidated Statement of Earnings

Consolidated Statements Of Earnings (USD $) In Millions, except Per Share data, unless otherwise specified	12 Months Ended			PROPORTIONS (f.)	
	Sep. 29, 2013	Sep. 30, 2012	Oct. 02, 2011	Sep. 29, 2013	Sep. 30, 2012
Net revenues:					
Company-operated stores	$ 11,793.20	$ 10,534.50	$ 9,632.40	79.19%	79.21%
Licensed stores	$ 1,360.50	$ 1,210.30	$ 1,007.50	9.14%	9.10%
CPG, foodservice and other	$ 1,738.50	$ 1,554.70	$ 1,060.50	11.67%	11.69%
Total net revenues	$ 14,892.20	$ 13,299.50	$ 11,700.40	100.00%	100.00%
Cost of sales including occupancy costs	$ 6,382.30	$ 5,813.30	$ 4,915.50	42.86%	43.71%
Store operating expenses	$ 4,286.10	$ 3,918.10	$ 3,594.90	28.78%	29.46%
Other operating expenses	$ 457.20	$ 429.90	$ 392.80	3.07%	3.23%
Depreciation and amortization expenses	$ 621.40	$ 550.30	$ 523.30	4.17%	4.14%
General and administrative expenses	$ 937.90	$ 801.20	$ 749.30	6.30%	6.02%
Litigation charge	$ 2,784.10	$ -	$ -	18.70%	0.00%
Total operating expenses	$ 15,469.00	$ 11,512.80	$ 10,175.80	103.87%	86.57%
Gain on sale of properties	$ -	$ -	$ 30.20	0.00%	0.00%
Income from equity investees	$ 251.40	$ 210.70	$ 173.70	1.69%	1.58%
Operating income	$ (325.40)	$ 1,997.40	$ 1,728.50	-2.19%	15.02%
Interest income and other, net	$ 123.60	$ 94.40	$ 115.90	0.83%	0.71%
Interest expense	$ (28.10)	$ (32.70)	$ (33.30)	-0.19%	-0.25%
Earnings before income taxes	$ (229.90)	$ 2,059.10	$ 1,811.10	-1.54%	15.48%
Income taxes	$ (238.70)	$ 674.40	$ 563.10	-1.60%	5.07%
Net earnings including noncontrolling interests	$ 8.80	$ 1,384.70	$ 1,248.00	0.06%	10.41%
Net earnings attributable to noncontrolling interest	$ 0.50	$ 0.90	$ 2.30	0.00%	0.01%
Net earnings attributable to Starbucks	$ 8.30	$ 1,383.80	$ 1,245.70	0.06%	10.40%
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	$ 749.30	$ 754.40	$ 748.30		
Diluted	$ 762.30	$ 773.00	$ 769.70		
Cash dividends declared per share	$ 0.89	$ 0.72	$ 0.56		

Table 7-2 Consolidated Balance Sheet

Consolidated Balance Sheets (USD $) In Millions, unless otherwise specified	Sep. 29, 2013	Sep. 30, 2012	PROPORTIONS (account out of total assets) (g.i.) Sep. 29, 2013	Sep. 30, 2012	PROPORTIONS (out of total equity)
Current assets:					
Cash and cash equivalents	$2,575.70	$1,188.60	22.36%	14.46%	
Short-term investments	658.1	848.4	5.71%	10.32%	
Accounts receivable, net	561.4	485.9	4.87%	5.91%	
Inventories	1,111.20	1,241.50	9.65%	15.10%	
Prepaid expenses and other current assets	287.7	196.5	2.50%	2.39%	
Deferred income taxes, net	277.3	238.7	2.41%	2.90%	
Total current assets	5,471.40	4,199.60	47.51%	51.09%	
Long-term investments	58.3	116	0.51%	1.41%	
Equity and cost investments	496.5	459.9	4.31%	5.60%	
Property, plant and equipment, net	3,200.50	2,658.90	27.79%	32.35%	
Deferred income taxes, net	967	97.3	8.40%	1.18%	
Other assets	185.3	144.7	1.61%	1.76%	
Other intangible assets	274.8	143.7	2.39%	1.75%	
Goodwill	862.9	399.1 [1]	7.49%	4.86%	
TOTAL ASSETS	11,516.70	8,219.20	100.00%	100.00%	
Current liabilities:					
Accounts payable	491.7	398.1	4.27%	4.84%	10.97%
Accrued litigation charge	2,784.10	0	24.17%	0.00%	62.11%
Accrued liabilities	1,269.30	1,133.80	11.02%	13.79%	28.32%
Insurance reserves	178.5	167.7	1.55%	2.04%	3.98%
Deferred revenue	653.7	510.2	5.68%	6.21%	14.58%
Total current liabilities	5,377.30	2,209.80	46.69%	26.89%	
Long-term debt	1,299.40	549.6	11.28%	6.69%	28.99%
Other long-term liabilities	357.7	345.3	3.11%	4.20%	7.98%
Total liabilities	7,034.40	3,104.70	61.08%	37.77%	
Shareholders' equity:					
Common stock ($0.001 par value)	0.8	0.7	0.01%	0.01%	0.02%
Additional paid-in capital	282.1	39.4	2.45%	0.48%	6.29%
Retained earnings	4,130.30	5,046.20	35.86%	61.40%	92.15%
Accumulated other comprehensive income	67	22.7	0.58%	0.28%	1.49%
Total shareholders' equity	4,480.20	5,109	38.90%	62.16%	99.95%
Noncontrolling interests	2.1	5.5	0.02%	0.07%	0.05%
Total equity	4,482.30	5,114.50	38.92%	62.23%	100.00%
TOTAL LIABILITIES AND EQUITY	$11,516.70	$8,219.20	100.00%	100.00%	

[1] In conjunction with the change in reportable operating

Table 7-3 Consolidated Statement of Cash Flows

Consolidated Statements Of Cash Flows (USD $)	12 Months Ended		
In Millions, unless otherwise specified	Sep. 29, 2013	Sep. 30, 2012	Oct. 02, 2011
OPERATING ACTIVITIES:			
Net earnings including noncontrolling interests	$8.80	$1,384.70	$1,248
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation and amortization	655.6	580.6	550
Litigation charge	2,784.10	0	0
Gain on sale of properties	0	0	-30.2
Deferred income taxes, net	-1,045.90	61.1	106.2
Income earned from equity method investees, net of distributions	-56.2	-49.3	-32.9
Gain resulting from sale/acquisition of equity in joint ventures	-80.1	0	-55.2
Stock-based compensation	142.3	153.6	145.2
Other	23	23.6	33.3
Cash provided/(used) by changes in operating assets and liabilities:			
Accounts receivable	-68.3	-90.3	-88.7
Inventories	152.5	-273.3	-422.3
Accounts payable	88.7	-105.2	227.5
Accrued liabilities and insurance reserves	87.6	23.7	-81.8
Deferred revenue	139.9	60.8	35.8
Prepaid expenses, other current assets and other assets	76.3	-19.7	-22.5
Net cash provided by operating activities	2,908.30	1,750.30	1,612.40
INVESTING ACTIVITIES:			
Purchase of investments	-785.9	-1,748.60	-966
Sales, maturities and calls of investments	1,040.20	1,796.40	430
Acquisitions, net of cash acquired	-610.4	-129.1	-55.8
Additions to property, plant and equipment	-1,151.20	-856.2	-531.9
Proceeds from sale of property, plant, and equipment	15.3	5.3	117.4
Proceeds from sale of equity in joint ventures	108	0	0
Other	-27.2	-41.8	-13.2
Net cash used by investing activities	-1,411.20	-974	-1,019.50
FINANCING ACTIVITIES:			
Proceeds from issuance of long-term debt	749.7	0	0
Principal payments on long-term debt	-35.2	0	0
(Payments)/proceeds from short-term borrowings	0	-30.8	30.8
Purchase of noncontrolling interest	0	0	-27.5
Proceeds from issuance of common stock	247.2	236.6	250.4
Excess tax benefit from exercise of stock options	258.1	169.8	103.9
Cash dividends paid	-628.9	-513	-389.5
Repurchase of common stock	-588.1	-549.1	-555.9
Minimum tax withholdings on share-based awards	-121.4	-58.5	-15
Other	10.4	-0.5	-5.2
Net cash used by financing activities	-108.2	-745.5	-608
Effect of exchange rate changes on cash and cash equivalents	-1.8	9.7	-0.8
Net increase/(decrease) in cash and cash equivalents	1,387.10	40.5	-15.9
CASH AND CASH EQUIVALENTS:			
Beginning of period	1,188.60	1,148.10	1,164
End of period	2,575.70	1,188.60	1,148.10
Cash paid during the period for:			
Interest, net of capitalized interest	34.4	34.4	34.4
Income taxes	$539.10	$416.90	$350.10

Case 8: BP p.l.c. - Contingencies

Introduction:

The purpose of this case is to better understand the implications of contingent liabilities. Although the Deepwater Horizon oil spill included the more extreme side of contingent liabilities and losses, it was helpful to look at the many possible costs related to the spill.

This case definitely helped me to better understand what exactly a contingent liability is. Contingent liabilities are not a topic that we have covered extensively in our classes up to this point, but it is definitely something that we will work with frequently as an auditor for big companies. This case will also be helpful for my future as an auditor because it made me think about the kinds of estimates and judgments I will need to make and also the preventative measures and boundaries.

Concepts:

a. **What is a contingent liability? Explain, in your own words, when a company would record a contingent liability (i.e. 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 could potentially occur, but is dependent on future events. A company would record a contingent liability on their books if it is probable that the contingency will occur and if it is "reasonably estimable." Some examples of contingent liabilities include product warranties, potential lawsuits, and pending investigations. A contingent asset is a potential asset that is dependent on future events, but unlike contingent liabilities, a company would never record a contingent asset.

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?

A product warranty serves a promise from the seller to the buyer that if a product does not work, the buyer can replace, return, or get the product repaired. So from BP's perspective, the product warranty is a guarantee from GE oil and gas that the telescopic joint will properly compensate for heave and offset on drilling vessels, and if they find in the next two years that it has any defects, BP can bring it back to GE for replacement or repair. From GE's perspective, a warranty is a way to ensure to BP and other customers that they believe that the telescopic joint will work as it is supposed to and it is also a guarantee that they will be loyal to the buyer and provide service if needed.

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?**

The primary judgments that management needs to make to account for contingent liabilities is deciding how likely the liability or loss is to occur, and also estimate the value of the loss. When accounting specifically for accrued warranty costs, management must estimate the cost that they expect to have to spend on repairs or returns as promised in the warranty for the duration of the warranty. This amount is estimated and recorded at the same time the product (and warranty) is sold.

A claim for damages resulting from the Deepwater Horizon oil spill differs from that of a warranty claim on a piece of equipment because a claim for damages from an oil spill arise from an unexpected event and the company likely did not prepare or set aside an expense account for potential damages. A warranty claim on a piece of equipment, on the other hand, is expected and estimated by the company and therefore accrued in an expense account so that the company maybe prepared when a customer

uses the warranty. Also, a warranty claim on a piece of equipment relates to defects of just one item, whereas a claim for damages from an oil spill could have been attributed to a whole number of defects.

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

BP must estimate the extent of the oil spill, so whom it affected including individuals, businesses, wildlife, and even the environment, and how much said parties were affected. BP must also estimate consequences of the oil spill. They need to decide who was hurt the most and how long they will be affected. They need to estimate the costs that they would be held liable for to pay the affected parties. Also, they need to estimate the expenses that would need to pay for recovery and repair of their own equipment and salaries of affected employees. Finally, they need to estimate the litigation ch

1. **If you were an auditor for BP, how would you draw a boundary around potential losses?**

If I were an auditor for BP, I would draw a boundary around only the potential losses that the company (BP) is 50 percent or more responsible for, as decided by myself and other hired actuaries and professionals. This would be a very difficult estimate to make, but it is important to have some sort of boundary so there is not an unlimited budget for things that may more may not occur. At the same time, however, we need to make sure the company has enough solvency and funds that they are able to pay when the losses do arise.

2. **List businesses that could sue and whether or not it is reasonable that they could sue.**

Businesses that could potentially sue BP include:

- Restaurants

- Lodging/Hospitality
- Car Dealerships/Rentals
- Retail
- Fishing/Oyster Harvesting/Crabbing
- Boaters

People who worked as fishermen, oyster harvesters, or crabbing could sue because they were unable to properly do their job due to the oil and residue that reeked havoc on the ocean life in the Gulf. Boaters were also affected by the ocean life because not only were the fishermen and oyster harvest no longer in need of boating service, but also no one was choosing to rent boats for trips on the water because it was not sanitary. However, it is the tourism industry that took the most major hit at the time, and during the years following, the spill. The beaches and water, which used to draw tourists year-round, were devastated and disgusting, and the affected areas lost a lot of business. Therefore, the businesses that were likely most affected by the oil spill and consequently would have ample reason to sue include restaurants, hospitality, car dealerships/rentals and retail.

Case 9: The Wendy's Company – Equity Method Investments

Introduction:

The purpose of this case is to gain a general understanding of why companies may undertake joint venture agreements and the effects of the companies' financials from these agreements. This case also allowed us to better understand the Equity Method of accounting and give us the opportunity to look at how that method affects real-life companies.

This case emphasized the fact that, when it comes to joint ventures, a lot of information can be found in the investment sections of the balance sheet. Also the footnotes of the financial statements provide vital information in understanding the details of the contracts and joint ventures. This case will be beneficial for my future as an auditor because it gave me a new level of familiarity with the financial statements of companies who do undertake joint venture agreements.

Concepts:

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

A joint venture is when two or more separate companies join together on one contract. Some reasons that companies would choose to enter into joint-venture agreements is because all of the potential negatives that are associated with new contracts are lessened because they are divided amongst the companies involved. Some of these potential negatives include risks (of failure or negative profit) and costs. There is also a lot more flexibility for companies in a joint venture.

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

The equity method of accounting is based on ownership interest in a joint venture or some other investment. If a company has between 20 percent and 50 percent ownership,

this means that they have significant interest in the investment, and the equity method can only be used when a company has this amount of control. The assets from the investment are recorded on the balance sheet. The proportion of ownership multiplied by the net income or the dividends of the investment are added to or subtracted from the investment value, respectively.

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?**

If an investor paid a price for the company that is great than the identifiable assets and liabilities, the investor therefore has goodwill. Book value and net assets are interchangeable terms (or equivalent to assets minus liabilities). The formal name of the excess is the Acquisition Accounting Premium (AAP). Companies separate the AAP into two parts. When the investor paid a higher price than the identifiable assets and liabilities, companies take part of the AAP and allocate the assets and liabilities of the investee to fair value at the time of the investment. This is an annual charge that the parent company makes to record the systematic amortization and depreciation within the equity investment account. The other part of AAP is written to goodwill. In the United States, companies do not amortize the goodwill portion, but instead they test it annually for impairments.

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

On their 2011 balance sheet, Wendy's recorded $91,742 for their equity investments. On their 2012 balance sheet, Wendy's recorded $89,370 for their equity investments. These appear on the investments part of the consolidated balance sheet.

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?

Fifty percent of Tim Hortons' net assets would equal $35,283. The equity investment account of Wendy's is $89,370. The excess amount of $54,087 is attributed to the AAP (it contains goodwill plus write-up to fair values).

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

a. 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?

Wendy's share of net income from their investment with Tim Horton in the year 2012 is $13,680, which is their equity earnings for the period. This number can be found in the "Other Operating Expense" section of the consolidated statement of operations.

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

Dr. Equity Investment 13680

Cr. Equity Income 13680

c. 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 purchase price adjustments are the amount of AAP allocated to the write-up to fair value, $3,129, found under "amortization of purchase price adjustments."

Dr. Equity Income 3129

Cr. Equity Investment 3129

d. 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.

The amount of dividends Wendy's received from TimWen in 2012 was $15,274, found under "distributions received."

Dr. Cash 15274

Cr. Equity Investment 15274

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

a. 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.

Investors only receive dividends in cash, not income. On the operating section of the cash flows statement, equity investments of $8,724 are subtracted from equity because while it increases net income, the company never received cash from them.

b. 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.

Dividends or "Distributions received" in the year 2012 of $15,274 are added back to the operating section of the cash flow when they are received because it decreases net income initially but the company does receive cash from the transaction.

Case 10: Johnson & Johnson – Retirement Obligations

Introduction:

The purpose of this case is build our understanding of the differences between the two different types of retirement plans, defined benefit and defined contribution. This case also delved deeper into the affects of actuarial gains and losses that arise from differences in the actual returns and expected returns on plan assets.

This case really helped to give me a better understanding of retirement obligation plans. One thing that I particularly liked about this case is that Johnson & Johnson is an international company with international employees, and that component of retirement plans is not one that we had talked about much in our intermediate class, so it was interesting to see the differences. I believe that this case will be beneficial for my future as an auditor primarily in knowing to look at the differences between actual and expected returns on plan assets and why they exist.

Concepts:

h. **There are two different types of retirement (i.e. pension) plans – defined benefit plans and defined contribution plans.**
    a. **How do these two types of plans differ? What type does Johnson & Johnson have?**

    A defined benefit plan is one where the employer provides a certain amount, which is guaranteed upon the employee's retirement and that amount is typically based on the employee's salary and number of years of service to the company. In a defined contribution plan, the employee contributes most of the funds to the plan, which can be matched by the employer periodically based on a formula.

    As stated in Note 13, Johnson & Johnson sponsors various retirement plans, including defined benefit, defined contribution and termination indemnity plans.

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

Retirement plan obligations are liabilities because they are the amount that the company owes to payment of the plan fund or to the employee.

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

Some assumptions that actuaries and companies must make in order to account for retirement plan obligations include employee turnover, mortality rate (how long employees will live), service years (how long employees are expected to work), and the salaries of their employees at the end of their careers.

i. **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 value of the benefit fund contributed each year of an employee's year of service. Interest cost is the interest paid on the beginning projected benefit obligation. Actuarial gains or losses are difference between the pension payments actually made by the employer and the returns on the plan assets expected. If actual is less than expected, there is a gain, and if actual is more than expected, there is a loss. Finally, benefits paid to retirees are the actual payment of benefits from the employer to the retiring employee.

j. **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 returns on pension investments are the dividends, interest and gains that the plan assets earn sitting in the company's pension fund. Company contributions are what the company pays to contribute to the plan assets. Finally, benefits paid to retirees are the actual payment of benefits from the employer to the retiring employee.

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

The "return on plan assets" pension expense is the expected return and the pension plan assets is the actual return. The rationale in this difference lies in whether the actual return is greater than the expected return or not. If the actual return is greater than expected, then there is a gain and pension expense is debited and therefore increased. If actual return is less than expected, pension expense is credited due to a loss and it decreases.

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

The primary difference between the company's other-benefits plans and its retirement plans is that, according to Note 13, "the Company does not fund retiree health care benefits in advance and has the right to modify these plans in the future." This is different than retirement plans in that Johnson & Johnson has a separate fund set aside that is contributed to periodically for retirement benefits and once an employee is set up on this plan, they are guaranteed the benefits upon retirement even if the company changes their plan. However, this note states that the company can change their health care plans at any time, and when they do, employees are not necessarily guaranteed the same benefits that they were before.

Process:

m. 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.

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

Johnson & Johnson reported $646,000,000 on its 2007 income statement.

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

Dr. Pension Expense 1,243,000,000

Cr. Pension Benefit Obligation 1,243,000,000

n. **Consider Johnson & Johnson's retirement plan obligation, that is, the pension liability, as detailed on page 62 of the company's annual report.**
    a. **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 million. This value represents how much money is needed to pay off the liability of the retirement plan to their employees. This is a fairly reliable number, as it takes into account gains and losses, contributions, expenses and changes in fair value. However, it could vary based on changes in the market.
    b. **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 million. The average interest rate the company must have used to calculate interest cost during 2007 equals 5.619 percent. This was found using the equation: (beginning PBO + PSC amendment) x settlement rate = interest cost. This rate seems reasonable because it falls between the domestic and international interest rates.
    c. **What amounts of pension benefits were paid to retirees during the year? Did Johnson and Johnson pay cash for these benefits? How do the benefits paid affect the retirement plan obligation and the retirement plan assets?**
    The amount of pension benefits that were paid to retirees during the year is $481 million. Johnson and Johnson paid for these benefits out of their plan assets, not with cash. Benefits paid decrease the retirement plan obligation and decrease the plan assets.

o. **Consider Johnson & Johnson' retirement plan assets that is, the pension plan asset, as detailed on page 62 of the company's annual report.**
    a. **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 and Johnson's retirement plan is $10,461 million. This value represents the fair value of the plan assets at the end of the period.

b. 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 was $701 million while the actual return was $966 million. In 2007, the expected return was $809 million and the actual return $743 million. These differences are very significant because they determine whether there is a gain or loss reported in other comprehensive income. In my opinion, the actual return better reflects the economies of the company's pension expense.

c. 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 and their employees contributed a total of $379 million to the retirement plan. This is $73 million greater than the $306 contribution in 2006.

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

The types of investments that are in Johnson & Johnson's retirement plan assets include equity securities and debt securities. In 2007, 79% of the investments are allocated to equity securities while 21% were allocated to debt securities (in regards to U.S. retirement plans).

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

The company's retirement plan underfunded in both 2007 and 2006. This funded status appears under "employee related obligations" on the company's balance sheet.

Case 11: On the Balance Sheet-Based Model of Financial Reporting

Introduction:

The purpose of this case was to inform us of the potential new changes that could occur in the accounting world. Previously, the balance sheet approach was more prominent than the income statement approach. This is because, when FASB became the primary standard setter of the U.S., the believed that companies should emphasize one or the other, but not both, and they believed that the balance sheet approach was the more logical of the two. This article goes through the many reasons why this is a bad idea, and why the income statement approach should be the major concern of companies and external users alike.

This case really made me think. As I mention later in the paper, in our classes, we seldom analyze the full balance sheet or income statement, so it never occurred to me that one could be more important to a firm than the other. So not only did this paper make me realize what I have thought about these two approaches initially, but it also changed my mind. I always thought that the balance sheet and income statement approaches were of equal importance, but now I am in agreement with the authors of the article, and believe that the income statement should be treated as the primary report, and the balance sheet, the secondary.

Finally, I will definitely use this information in my future career as an auditor. I feel like I can confidently discuss the current repercussions of emphasizing the balance sheet, and why the income statement should be the primary instead. Also, this change could change many auditing standards and procedures, so it is good that I am being made aware of them now, so I might be prepare for what is to come in the future.

Summary:

This article begins with the introduction of a much-needed debate in the accounting world regarding the proper conceptual foundations of accounting, Currently, the balance sheet approach to financial reporting is superior in use to the income statement approach. The suggested change to put more prominence in the income statement approach develops from an effort to combine FASB and IASB so it is easier for companies to agree on specific issues that might be unclear at this point. The effect of this change will have an extensive impact on financial reporting for years. The ultimate goal of this change is to achieve uniformity and comparability. The authors of this article go into detail, first touching on the history of FASB, IASB, and each approach, and then discussing the main critiques of the balance sheet approach.

The balance sheet approach places an emphasis on assets and liabilities as the primary goal, whereas the income statement approach implies that revenues, expenses and earnings are the primary goal. The income statement approach is supported by the revenue recognition and expense principles. This approach is also intended for analysts and managers best interest because stock value, the primary concern of these parties, arises from the firm’s ability to generate earnings.

When the article first dives deeper into the history of the balance sheet and income statement approaches to give readers insight into where the problem arose, they make it clear that both approaches have always existed in financial reporting. However, the income statement was the more relied upon statement, until the mid-1970’s when the emphasis switched to the balance sheet after FASB became the primary standard setter in the U.S. When FASB came about, they did a major reconstruction, first issuing the all-important

preliminary views. They ultimately determined that, while the balance sheet and income statement approaches were undoubtedly the two major approaches in financial reporting, companies had to chose between one or the other in order to reduce inconsistencies, so they deemed the balance sheet approach to be the more logical of the two. Since this, FASB has been transitioning old rules to the new framework, primarily overriding income statement approaches with that of the balance sheet style, as the article suggested in the example of APB Opinion 11. Also, the balance sheet has expanded from US to international because IASB was modeled after FASB, so both are committed to the balance sheet approach.

The first major critique that the author mentions in the article is, "The balance sheet approach is problematic because it is at odds with how most businesses operate, create value and are managed." The premise of this issue is that the balance sheet focuses on assets, so if the primary goal of a company was to earn money solely revolving around assets, the balance sheet would be ideal, but that is not the goal of companies. Also, managers prepare forecasts of revenues and expenses before they even consider assets necessary for support to these predictions. Finally, the income statement approach more clearly reveals success in business operations.

The second major critique of the article is, "the alleged conceptual superiority of the balance sheet approach is unclear. If anything, one can argue that the concept of income provides a clearer and stronger foundation for financial reporting." Undoubtedly, income and assets are connected. No company or firm can have one without the other. However, FASB thinks they can be separated and have assets as the primary account, but if anything, revenue should be primary because it is a clearer number and easier for analysis purposes.

The thirst critique states, “balance sheet accounting is likely a major contributor to the substantial temporal decline in the forward-looking usefulness of earnings.” Investors care about recurring earnings to predict the future stream, not changes in assets. However, the balance sheet approach has made earnings precarious and less “persistent”, so they are not as helpful in predicting future earnings, which could lead to earnings becoming completely meaningless in a few decades, putting investors at risk.

Finally, “there are substantial problems with applying the balance sheet-based model of accounting in practice.” Firstly, the balance sheet is more subjective as it leads to errors and deliberate manipulation. It also puts too much emphasis on the market affects.

The article ended with suggestions for improvement on the current views of these concepts. They focused on a clear distinction between assets in operating and financing activities. The reasoning for this is because the income statement approach is more appropriate for operating activities, while the balance sheet is better for financing. Also, there should be more specifications for matching principle and revenue recognition. They are the two most important principles in accounting for companies, and while the revenue recognition is comparatively more straightforward and matching is more complicated and leaves more room for error, matching is vital to how businesses run.

How did this change your current way of thinking?

This article was an interesting read because it first brought to my attention my current way of thinking, and then changed it. In class, we seldom have to do our own analysis on a business and their successes. In fact, we rarely are even given full balance sheets or income statements to look at and use, but instead are shown portions of the relevant information in order to complete the exercises that we need to. Also, I don't believe I have made a full balance sheet or income statement since Accounting 201 or 202. Due to this, I had never really thought about which approach was better for financial reporting. Upon the article introduction, and realizing what the purpose of the article was, I suppose I would have said that the two are equally important and necessary for internal and external users alike.

However, after completing the article, my view of the topic has definitely changed. I am in agreement with the authors, and believe that the emphasis should be put on the income statement, with the balance sheet as a secondary report. Throughout my tenure as an accounting student, I have thought that revenues were the most telling of a business' successes and extremely beneficial in forecasting the future of the company. Revenues are also good for comparability, both internally and against competitors.

The article seems to put the blame of this situation on FASB. The income statement approach was the more relied-upon statement until FASB became the primary standard setter in the U.S. When they did their reconstruction, they realized that many companies were prioritizing either the income statement or the balance sheet approach, so for comparability and consistency, they decided that the balance sheet was the more logical of the two. While I think their decision to pick one over the other was smart, I do not

understand why they picked the balance sheet over the income statement. Again, assets, liabilities and equity are important, but as the article mentions, the goal of a company isn't to earn money by "acquiring, storing and growing assets," it is to generate earnings. Assets are simply resources used to generate these earnings.

The balance sheet is definitely still an important report and holds information that is vital to the company's operations. However, I think the balance sheet should be used more for internal users of the company. While it should be sent to external users, I think it is fair to say that managers might care more about specifics regarding things like PPE and than an investor would, at least in comparison to revenues and expenses.

It was also interesting to read how the balance sheet approach is ruining the usefulness of earnings. This was also something I had never considered before, but it makes sense. If people are putting too much emphasis into the accounts on the balance sheet, they are going to stop caring about earnings because it makes them seem more risky.

In conclusion, this article not only gave me an initial way of thinking, but it also changed it. I had always looked at the balance sheet as equally important to the income statement, but after this article, I agree that the income statement approach should be the primary report.

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.

This information will definitely be useful in my future career. As auditors, we will be working closely with the financial statements so it is important to know which one we need to place the most emphasis on. Again, as stated earlier, I always thought an equal importance was placed on both the balance sheet and the income statement, but currently most companies use the balance sheet approach as their primary form of financial reporting. Of course I do not know the logistics of a day in the life of an auditor, as I have not had that experience yet, but if it is true that the balance sheet is the priority, I am sure the staff spends the most time analyzing, checking and comparing using that report.

Everything could be different if this change were to actually go through. It would be interesting to see whether how immediate the change would be. Also, I'm sure there be many different auditing standards and procedures that I would have to learn. Even in the article, the authors mentioned a plethora of rules that the FASB has changed to convert from a more income statement approach concept to the balance sheet approach.

Also, I hope to work abroad for a few years in my career so I am sure this change would affect international standards and IASB. As the article discussed, the IASB was created after FASB, so they were, for the most part, very conceptually similar in an effort to maintain consistency. However, that was probably an easier creation because IASB was developed after FASB. This would likely be the biggest change FASB had ever undergone, so I am curious to see if IASB would follow suit in the change, or go through a more gradual timeline, if anything.

In conclusion, this information will be very useful in my future career. Firstly, I feel like I can speak more intelligently on the subject, which will be useful in impressing my peers at happy hour. Also, if this change is enacted after we have already started our jobs or internships, it could completely rearrange the way we do our work. Our focus could shift dramatically from the balance sheet to the income statement. In addition, we would have to learn more rules and standards so we go through our procedures accurately. Also, this change could through IASB into frenzy because it is such a major change, and IASB is pretty similar to FASB.

Case 12: Google Inc. – Earnings Announcements and Information Environment

Introduction:

Over the course of this year, I have realized that I enjoy learning about accounting principles and technicalities more and more every week. Although I still would not search for articles on these topics and read them in my spare time, I find them interesting and appreciate that I can have an intelligent conversation with my superiors about the topics we have learned about in these cases.

As with every other case, I learned something new. Perhaps I just did not get a complete grasp when we discussed these in class, but I did not realize that EBIT, EBITDA and similar financial measures were not GAAP, meaning that they exclude information included in, or include information excluded in comparable GAAP measurements. I have never noticed these measures included in a company's financial information before, but after reading the supplemental article, I understand why companies want to report these numbers. While some say that companies present these earnings to distract from poor or negative growth on a GAAP basis or to overturn a loss, I think that these numbers are truly beneficial for investors. Hopefully investors will be knowledgeable enough not to put all of their faith solely in these measures when analyzing performance of a company, but at the very least they give an insight into management's perspective. While they are not comparable to other companies, they can help management draw comparisons year-to-year. Obviously these numbers are relevant, because the number of companies that use them are on the rises, and FASB is developing a more definitive framework for these measurements when featured on financial statements. This information will be useful when I am an auditor because I know not to depend on these numbers, but still consider what they mean for the internal operations of the company.

In terms of the case outside of the article, I do not invest my money in stocks currently, but I enjoyed looking at and analyzing the stock charts. My parents check and sometimes worry about their stock investments everyday, so it was interesting to see how much they fluctuate over the course of year. Fiscal year 2013 had a few severe dips for Google, but in the end the stock price increased greatly. This information will not only be beneficial for my future as an accountant, but also as a person investing money in the stock market. I understand that stocks may drop every week or so, but the real thing that matters is result in the long run.

Analysis:

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

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

The difference between GAAP net income and the non-GAAP equivalent can be explained by the fact that management has excluded certain expenses that they do not believe to be relevant to the company's core business operations. The non-GAAP financial measures exclude non-cash charges and discrete cash charges that are rarely occur. Some of the adjustments made to reconcile GAAP to non-GAAP include elimination of the following: stock-based compensation expense,

restructuring and related charges, income tax expenses related to those expenses, and net loss from discontinued operations. I agree with each of the adjustments made when computing the non-GAAP earnings. According to the article we received in class, "a company may make any adjustment it believes appropriate, subject to Item10(e)", which states that "it is prohibited to eliminate items that are "non-recurring, infrequent, or unusual" that has occurred in the past two years or is likely to occur in the next two years. I do not believe any of the adjustments fit this prohibition, so therefore the adjustments are valid.

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

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

Google's fiscal 2013 earnings performance appears to follow the movement in Google's stock price over 2013. Over the course of the fiscal year, the earnings gradually increased each quarter, and as seen in the stock chart, so did the stock price. The stock price had a few dips over the course, which is to be expected, but none of the dips seemed to have an overwhelming affect on the ending earnings amount each quarter.

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).

Looking at the Google vs. NASDAQ Index chart, it is clear that both performances follow the same trend, as both increased over the course of the fiscal

year. However, the ending stock return of GOOG (about 65%) was almost twice that of NASDAQ (about 35%). Also, Google stock price suffered from much more drastic drops and recoveries over the course of the year than NASDAQ, as most clearly seen in early 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.

Based on the chart, it appears that the market perceived the earnings news as "good news." Assuming that the Q4 earnings arrow on the chart is pointing to January 30, there is very clearly a spike in the earnings for this day. Although it quickly decreases again in the next few days, it gradually works its way back up by February 14.

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

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

According to the article, Google's fourth quarter revenue and earnings of $16.9 billion was only $1 million greater than the $16.8 billion that was predicted by Thomson Reuters analysts. The article credits this increase to the growth in Google's core advertising business. These relations are consistent with the positive

stock market reaction following the press release. The market likely saw in the press release that Google was doing better than expected, and speculated that this high performance would likely continue, so they quickly bought in.

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

Some other factors discussed in article that could have contributed to the market's positive reaction include the higher than expected earnings per share, growth in search advertisements, improvements for smartphone technology, and a strong in performance in the sale of the Google Play app. Also, the stock price increased by over $1 per share. However, there are some factors that might cause investors to be concerned about Google's recent performance. Mainly, the article mentions that Adobe said that the cost per click of ads increased 80% in the fourth quarter, and while it did not lead to a decline in return for advertisers, if the costs continue to increase, it very well could negatively affect the return.

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Honor Code:

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

Signed: