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A Compilation of Case Studies Focusing on Financial Reporting Issues

By

Haydn Brown

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

2020

Approved By



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Advisor: Dr. Victoria Dickinson



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Reader: Dr. W Mark Wilder

## **Abstract**

The following thesis is a compilation of case studies that focuses on various financial reporting and accounting topics. Each case addresses different topics using real world examples of specific companies. The thesis demonstrates the understanding of Generally Accepted Accounting Principles and was completed under the supervision of Victoria Dickinson to satisfy the requirements for the University of Mississippi, Sally McDonnell Barksdale Honors College, and Patterson School of Accountancy, and ACCY 420 course in the 2018-2019 academic year.

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Case 1

Data Analytics Tool

Analysis of Python

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## **Overview**

Python is an open-source programming language that was created in the late 1980's and now can be used as a data analysis tool. Within the Python programming language there are libraries, and the data analysis library is called Pandas. There are also more specified libraries that can be used for deeper statistical tools and analysis. It can turn data in a CSV file, TSV file, or a SQL database into an object called a dataframe, which is similar to an excel spreadsheet, that is significantly easier to work with than lists or dictionaries in other database analysis tools. Python, and Pandas, is used to analyze enormous amounts of data and convert it to a useable and easy to read format for users.

### **Applications of Python – Auditing**

3a. The name “pandas” is derived from the phrase “panel data” which is a common term for data collected at regular intervals over a given period of time. This concerns the accounting and data analysis industries directly; accounting data is almost exclusively panel data. A firm could use this to determine where to focus the audit team within a company by analyzing prior auditing information. Python, in conjunction with Pandas, could be used to write any program one could want. This includes anticipating and modeling future sales returns, receivables, or payables so that the audit team can then compare those to the actual values.

### **Applications of Python – Tax Planning**

3b. NumPy, a scientific computing library within Python, can be used to produce complicated calculations and matrices for any purpose. NumPy and Pandas can be used in conjunction to perform these calculations on vast amounts of data and convert it into a useable

form. Using both libraries allows powerful data manipulation and calculation, especially for tax purposes. Code could be written to calculate tax, analyze prior period's calculations, or find major differences between the current period and other period's tax data. The latter would need little human input once the code has been written and therefore would streamline the process immensely. NumPy and Pandas, especially when used together, are especially useful in tax planning due to their potential for streamlining and improvement to the entire process.

**Memo to Partner**

TO: Vicki Dickinson

FROM: Haydn Brown

DATE: September 4<sup>th</sup>, 2018

SUBJECT: Python as a Data Analytics Tool

Python, as a data analytics tool, would be a great addition to our firm's tools and resources. It is currently the third most popular programming language, with Java and C taking the top two spots. Two of Python's libraries, Pandas and NumPy, would be the most useful to our department as they were created for complex calculations and data manipulation and wrangling. It is one of the easiest programming languages to learn, especially if transferring from R, a common statistical programming language. Python is open source; there would be no cost to acquire the actual software. However, there would be costs in order to support and manage the software, as well as training employees to use the software.



Our department would need to hire or train at least one person to become fluent in Python, and it would be especially beneficial if that person had a background in data analytics as well as accounting. This person would have to train the rest of the department on how to do simple tasks in Python, or he or she could write all the code that the department would need. The latter option, especially as Big Data gets bigger and bigger, could snowball into too much work for just one person. A second Python programmer could be needed to satisfy the department's needs; however, he or she could be hired once we have implemented Python as our data analytics tool.

Using Python would allow us to increase the scope of our projects and possibly take on more advanced projects and clients, depending on how the department takes advantage of this powerful software. Investing our department's resources into Python would be a great opportunity to differentiate us from our competitors and continue to maintain a competitive advantage over them.

## Case 2

# Rocky Mountain Chocolate Factory

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## **Executive Summary**

While completing this case, I learned many things that could prove to be useful in Excel. I have used Excel extensively in the past; however, I did not use cell references as much as I did in this spreadsheet. In accounting, things do not always balance the first time you do the calculations. Whenever a correction is made, as long as the formulas and cell references are done correctly, the correction is carried out through the rest of the spreadsheet. I can also see Excel being a powerful tool when needing to graph accounting information that has been collected over a period of time, especially if each spreadsheet is formatted the same.

## **Expectations of Accounts**

I expect to see typical accounts of a manufacturing and merchandising business, such as cash, accounts payable, accounts receivable, inventory, PP&E, and long term assets. There will also be common stock, retained earnings, dividends. There may be other equity accounts, depending on how the corporation is financed.

## **Proposed Adjustments or Reclassifications**

Interest Income should be listed as a revenue account with a normal credit balance, similar to Sales or Franchise and royalty fees. There are two other accounts listed under assets, these should be designated as Other current assets and Other long-term assets.

# General Journal

	Beginning Balance 2/28/2009	1. Purchase Inventory	2. Incur Factory Wages	3. Sell inventory for cash and on account	4. Pay for Inventory	5. Collect Receivables	6. Incur SG&A (cash and payable)	7. Pay Wages	8. Receive Franchise Fee	9. Purchase PPE	10. Dividends declared and paid	11. All other transactions	Unadjusted Trial Balance	12. Adjust for inventory count	13. Record Depreciation	14. Wage Accrual	15. Consultants report	Preclosing Trial Balance	16. Closing Entry	Actual February 28, 2010 F/S Figures
Cash and Cash Equivalents	1,253,947			17,000,000	(8,200,000)	4,100,000	(2,000,000)	(6,423,789)	125,000	(498,832)	(2,403,458)	790,224	3,743,092					3,743,092		3,743,092
Accounts Receivable	4,229,733			5,000,000		(4,100,000)						(702,207)	4,427,526					4,427,526		4,427,526
Notes Receivable, current	-											91,059	91,059					91,059		91,059
Inventories	4,064,611	7,500,000	6,000,000	(14,000,000)								(66,328)	3,498,283	(216,836)				3,281,447		3,281,447
Deferred Income Taxes	369,197											92,052	461,249					461,249		461,249
Other	224,378											(4,215)	220,163					220,163		220,163
Property and Equipment, net	5,253,598								498,832			132,859	5,885,289		(698,580)			5,186,709		5,186,709
Notes Receivable, less current portion	124,452											139,198	263,650					263,650		263,650
Goodwill, net	1,046,944												1,046,944					1,046,944		1,046,944
Intangible Assets, net	183,135											(73,110)	110,025					110,025		110,025
Other	91,057											(3,007)	88,050					88,050		88,050
Accounts Payable	1,074,643	7,500,000			(8,200,000)							503,189	877,832					877,832		877,832
Accrued Salaries and wages	423,789		6,000,000					(6,423,789)					-		646,156			646,156		646,156
Other accrued expenses	531,941						3,300,000					(2,885,413)	946,528					946,528		946,528
Dividend Payable	598,986										3,709	(1)	602,694					602,694		602,694
Deferred Income	142,000								125,000			(46,062)	220,938					220,938		220,938
Deferred Income Taxes	827,700											66,729	894,429					894,429		894,429
Common Stock	179,696											1,112	180,808					180,808		180,808
Additional Paid-In Capital	7,311,280											315,322	7,626,602					7,626,602		7,626,602
Retained Earnings	5,751,017										(2,407,167)		3,343,850					3,343,850	3,580,077	6,923,927
Sales	-			22,000,000								944,017	22,944,017					22,944,017	(22,944,017)	-
Franchise and Royalty Fees	-											5,492,531	5,492,531					5,492,531	(5,492,531)	-
Cost of Sales	-		14,000,000									693,786	14,693,786	216,836				14,910,622	(14,910,622)	-
Franchise Costs	-											1,499,477	1,499,477					1,499,477	(1,499,477)	-
Sales and Marketing	-						1,505,431						1,505,431					1,505,431	(1,505,431)	-
General and Administrative	-						2,044,569					(261,622)	1,782,947		639,200			2,422,147	(2,422,147)	-
Retail Operating	-						1,750,000						1,750,000			6,956		1,756,956	(1,756,956)	-
Depreciation and Amortization	-												-	698,580				698,580	(698,580)	-
Interest Income	-											(27,210)	(27,210)					(27,210)	27,210	-
Income Tax Expense	-											2,090,468	2,090,468					2,090,468	(2,090,468)	-

## Income Statement

Rocky Mountain Chocolate Factory, Inc.		
Income Statement		
For the Year Ended February 28, 2010		
Sales		\$ 22,944,017.00
Franchise and Royalty Fees		\$ 5,492,531.00
Cost of Sales		<u>\$ 14,910,622.00</u>
Gross Margin		\$ 13,525,926.00
Operating Expenses		
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	
Income Tax Expense	<u>\$ 2,090,468.00</u>	
Total Operating Expense		<u>\$ 9,973,059.00</u>
Net Operating Income		\$ 3,552,867.00
Interest Income		<u>\$ 27,210.00</u>
Net Income		\$ 3,580,077.00

## Cash Flow Transactions

Rocky Mountain Chocolate Factory, Inc.	
Transaction History	
For the Year Ended February 28, 2010	
1. Purchase Inventory	Operating Activity
2. Incur Factory Wages	Operating Activity
3. Sell inventory for cash and on account	Operating Activity
4. Pay for Inventory	Operating Activity
5. Collect Receivables	Operating Activity
6. Incur SG&A (cash and payable	Operating Activity
7. Pay Wages	Operating Activity
8. Receive Franchise Fee	Operating Activity
9. Purchase PPE	Investing Activity
10. Dividends declared and paid	Financing Activity
11. All other transactions	N/A
12. Adjust for inventory count	Operating Activity
13. Record Depreciation	Operating Activity
14. Wage Accrual	Operating Activity
15. Consultants report	N/A

## Balance Sheet

Rocky Mountain Chocolate Factory, Inc.		
Balance Sheet		
For the Year Ended February 28, 2010		
<b>Assets</b>		
Current Assets		
Cash and Cash Equivalents	\$ 3,743,092.00	
Accounts Receivable	\$ 4,427,526.00	
Notes Receivable, current	\$ 91,059.00	
Inventories	\$ 3,281,447.00	
Deferred Income Taxes	\$ 461,249.00	
Other	\$ 220,163.00	
Total Current Assets		\$ 12,224,536.00
Long Term Assets		
Property and Equipment, net	\$ 5,186,709.00	
Notes Receivable, less current portion	\$ 263,650.00	
Goodwill, net	\$ 1,046,944.00	
Intangible Assets, net	\$ 110,025.00	
Other	\$ 88,050.00	
Total Long Term Assets		<u>\$ 6,695,378.00</u>
Total Assets		<u>\$ 18,919,914.00</u>
<b>Liabilities and Stockholder's Equity</b>		
Current Liabilities		
Accounts Payable	\$ 877,832.00	
Accrued Salaries and wages	\$ 646,156.00	
Other accrued expenses	\$ 946,528.00	
Dividend Payable	\$ 602,694.00	
Deferred Income	\$ 220,938.00	
Total Current Liabilities		\$ 3,294,148.00
Long Term Liabilities		
Deferred Income Taxes	\$ 894,429.00	
Total Long Term Liabilities		<u>\$ 894,429.00</u>
Total Liabilities		\$ 4,188,577.00
Stockholder's Equity		
Common Stock	\$ 180,808.00	
Additional Paid-In Capital	\$ 7,626,602.00	
Retained Earnings	\$ 6,923,927.00	
Total Stockholder's Equity		<u>\$ 14,731,337.00</u>
Total Liabilities and Stockholder's Equity		<u>\$ 18,919,914.00</u>

## Case 3

### Proposed Scenario Analysis



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## **Overview**

This case will be based on a class discussion where three scenarios were presented to the class, and we were instructed to defend our positions on each one. I will analyze the argument and choose a position for each scenario. I will then give concluding thoughts at the end.

## **Tax Law vs. Tax Accountant**

This scenario presented a conversation between two accounting students, one planning to go to law school and then work in tax law, and the other planning to receive master's in accounting and then work in a tax position at a public accounting firm. Both students plan to do an internship at a public accounting firm. There are many benefits to going to law school, even if a student never intends to practice law. In terms of the accounting industry, earning a law degree in addition to an accounting undergraduate degree could help a student easily transfer to corporate law, or have a better understanding of law in general. It also provides an opportunity to network and meet people outside of the accounting discipline. In this scenario, the student had already decided that he/she wanted to work in tax law after law school, but if he/she did not know exactly what they wanted to do after school, law school would be a way to discover new career fields and paths. Because the student already wants to work in tax, he/she may want to forego law school, especially if he/she wants to work at a public accounting firm. Law school can be quite expensive, and it prolongs the amount of time until the student enters the workforce, subsequently prolonging the time until earning a salary. While this may not be an important factor to all people, many students grow tired of being in school after earning an undergrad degree, and they are excited and ready to get a job.

## **Public Accounting vs. Non-Accounting Career**

The scenario presented was another conversation between two accounting students, one who does not enjoy accounting and plans to go into another field once completed with school, the other who plans to work at a public accounting firm once completed with school. It is quite common to get an accounting degree, but never work as an accountant. One of the most versatile degrees, accounting teaches critical thinking and problem solving skills that can be applied to many career fields. However, if a student already knows the field or industry that he/she wants to work in, perhaps double majoring in that field is the best option. This is not an easy endeavor to take on, but it is a decision that appeals to future employers and demonstrates dedication and good work ethic. Unfortunately, all students are not able to do this, whether because of financial restrictions, the increased class time in order to double major, or they simply cannot handle the increased workload. Even without double majoring, accounting can be a useful degree no matter what career. As stated in the prior scenario, accounting teaches critical thinking and problem solving skills that are applicable to many career fields. Generally, more money can be made in public accounting compared to other industries, especially directly out of college. However, compared to working in industry, public accountants work longer hours and their jobs are significantly more demanding than most accounting jobs in industry. Accounting provides useful and widely applicable skills that can be applied to any career, even if it is not public accounting.

## **Switching a Job Offer to a Different City**

The scenario presented was an email exchange between a professor and current graduate student. The graduate student was seeking advice about trying to transfer a job offer from the Washington D.C. office of Firm A, to the Dallas office of Firm A. He had already completed an internship in the D.C. office, but his hometown is Dallas and he wants to return there. He was not sure how to start the conversation with his firm, and he was due back in D.C. to start his job in a few months. The professor replied, telling him that the best way to work for Firm A in Dallas was to work in D.C., show them that you are a high-achieving and driven employee, and pursue a transfer to Dallas in a few years. In this situation, I think the student should have informed the D.C. office that he was seeking a transfer as soon as he realized he wanted to return to Dallas. Being open and honest about your intentions with your superiors is the best way to maintain positive professional relationships. Your superiors will hopefully understand the requests, and the worst that could happen is the request is denied. If the request does get denied, the superior will at least know that he is looking to transfer, and will most likely inform him of any opportunities to transfer. I agree with the professor; the best way to continue working for Firm A is to prove yourself to be an asset to the firm and continue seeking a transfer.

## **Conclusion**

All of these scenarios presented an opportunity to discuss with both my peers as well as the professor, who has extensive experience in these matters. However, in all of these scenarios, working in public accounting was the main focus. While I understand that the Big 4 firms recruit heavily from the University of Mississippi, I wish that one of the scenarios was between working at a public accounting firm and working in industry. I would enjoy the professor's and my peers' viewpoints on that topic. Other than that topic, I learned that many of my views come off as unpopular to some people, and that I will have to learn how to get my point across without offending people. This discussion gave me more insight to how the firm's internship process works, and how the firm's operate as a whole.

## Case 4

# Generic Bank: Accounting for Debt Securities Sales and Impairments

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## **What I Learned**

While completing this case, I gained insight into the industry and practices of the banking industry, while also learning to apply accounting principles to the banking industry. The fact that banks have little to no equity should not be overlooked when examining the United States economy, especially in the wake of the financial crisis in 2007 and 2008. I learned how banks are financed, and what type of regulations are imposed on their capital ratios so that they are not overly risky. I was aware of bank regulators, but not the extent of their job. Regulators, unlike auditors, are there to examine and, if necessary, enforce regulations set forth by the many federal and state government agencies. While I am usually against regulations, I believe that the job of regulators is extremely necessary to throttle banks from misusing customer's money, and in extreme conditions, losing customer's money. Auditors are in place to protect investors' interest, and regulators are there to protect the public's interest.

Besides the information on banking and accounting practices, I also learned that, in the real world, information must be sought after, not given to you by a professor. Some may argue that going to college and attending class would classify as the information being sought after, but when compared with the task of combing the internet for the one sentence you are looking for, receiving information from a professor is easy. When working at a large company or firm, coworkers or superiors are not always present or able to answer questions. To find information, you have to search for it, which is almost never straightforward.



### **Impairment Loss on Selected Securities**

No, Generic Bank does not have an impairment loss on all seven securities. The securities with CUSIP numbers ending in 003, 015, 025, 030, and 076 were all sold at a loss; their amortized cost was greater than their fair value. Generic Bank would need to have the intent and ability to hold until the unrealized losses recover in order to not recognize the impairment loss, according to ASC 320. It also lists a number of statements that define an intent to sell; two of these are directly related to Generic Bank's situation. One states that there is an intent to sell if the decision to sell is made shortly after the balance sheet date, and another states that there is an intent to sell if the securities are marketed at a price "that does not significantly exceed fair value." Out of the seven securities that were sold, only two of them sold above fair value. Because its stated that Generic Bank sold the seven securities shortly after year end, this equates to shortly after the balance sheet date. Therefore, Generic Bank would only need to recognize an impairment loss on the five securities that were sold at a loss position.

### **Extent of Impairment Across Portfolio**

Generic Bank has not sold, or declared their intent to sell, any other securities besides the seven mentioned in the earlier requirement. ASC 320 states that if the intent to sell does not exist, the entity must next determine whether it is more likely than not that it will be required to sell the impaired debt security before recovery of its amortized cost basis. To determine this, there are two items that must be considered, if there are any factors (e.g., capital restraints or regulation) that would require the entity to sell them, and the probably that those factors will occur within the recovery period, the time it takes for the amortized cost basis to meet or exceed the security's fair value. According to what is stated in the case, Generic Bank is well capitalized; and therefore it is not more likely than not that the securities will need to be sold. Therefore, Generic Bank would not recognize an impairment on securities other than the seven that were sold.

### **Other Perspectives of Impairment**

My answers do not change when I assume the role of an external auditor or bank regulator, as an employee should not allow bias into their analysis of a situation because they are an employee. In an ideal world, auditors and regulators would not be necessary, as no one would make mistakes or attempt fraudulent accounting practices. However, additional factors that should be examined would include historical practices of Generic Bank, any major change in management or employees that has occurred since the last audit, or any major change in the overall culture of the bank.

### **Impairment of Securities in a Net Gain and Gain Position**

My answer for requirement one would not change if the securities sold were collectively in a net gain position. Impairment would still be recognized for the individual securities that were in a loss position, especially because there was not an impairment recognized for the securities that were in an individual gain position, despite the fact that the group of securities was in a net loss position. My answer for requirement two would not change if the securities sold were in a net gain position; impairment would still be recognized on unsold securities that were in a loss position. If all securities sold were in a gain position, my answer for requirement one would change. There would not be an impairment recognized for securities sold; there is no need due to the fact there would be no loss to recognize. My answer for requirement two would not change if securities sold were all in gain positions; the positions of unsold securities has not changed and therefore my answer has not changed.

### **Impairment of Portfolio**

Yes, Generic Bank would recognize an impairment loss on other securities besides the seven sold. Generic Bank's access to other methods of borrowing in order to meet liquidity needs has become limited; they are no longer well capitalized, and therefore it is more likely than not that they will be required to sell other securities in order to improve capital ratios. Generic Bank has lost their ability to hold their securities until the end of the recovery period, and should recognize an impairment loss on all securities that are in a loss position.

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## Case 5

### Analysis of Two Cities as Places to Start Career

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## **Population**

The 2018 population estimate of New York City is 8,622,698. The 2018 population estimate of Charlotte is 872,498.

## **Climate**

In the summer New York City is relatively warm, with average highs in the mid-eighties and average lows in the high sixties. During the winter, average highs are in the low forties and average lows are in the high twenties. Snow is expected during the beginning of the year; however only for a couple months.

In the summer, Charlotte's average highs are in the mid-to-high eighties with average lows in the high sixties. During the winter, average highs are in the low fifties with average lows in the mid-thirties.

## **Geography**

New York City is an extremely urban area located in the southeast corner of the state of New York, on the Atlantic Ocean. There are two rivers that run through it, the Hudson and the East River.

Charlotte is a medium sized city located in the southern United States. There are no large bodies of water near the city, besides a few lakes in the surrounding areas. North of Charlotte lies the beginning of the southern Appalachian Mountain range.

## **Tax Implications**

The NYC tax \$1,814, NYS tax 2,888, federal tax 6,945. Federal tax rate for the same salary is \$4,453.50 plus 22% of the amount over \$38,700, for salaries under \$82,500, so I would I have to pay \$6,940 of federal tax. The state tax rate for a salary of \$50,000 is 5.78%. The city tax for a salary of \$50,000 is 3.63%.

North Carolina has a flat state income tax rate of 5.499% for 2018. This means that with a salary of \$50,000, I would have to pay \$2,750 of state tax. Federal tax rate for the same salary is \$4,453.50 plus 22% of the amount over \$38,700, for salaries under \$82,500, so I would have to pay \$6,940 of federal tax. I would have to pay \$9,690 in taxes.

## **Airports**

There is one major airport in Charlotte, the Charlotte Douglas International Airport. It is a major hub for American Airlines and in 2016, it was the eleventh busiest airport in the United States. There are three main airports in New York City, with two in Queens and one in Newark. John F. Kennedy International Airport and LaGuardia Airport are both in Queens, while Newark International Airport is located in New Jersey. Grand Central Station is located in Manhattan, and is a main commuter hub for the city. It is not owned or operated by the city, but rather a private company. It has access to the subway system, the busiest transit system in the Western World. The subway system is the main method of transportation within the city.



## **Major Industries**

Obviously, one of New York's most significant industries is banking and financial services. Wall Street can be credited for the dominance of this industry, with the majority of all investment firms in the United States located in the city. Many firms have attempted to operate outside of the city; however, the time it takes for the transactions to occur when located in other parts of the country, especially when making millions of transactions a day, costed the firms money because the prices of stocks changed in the milliseconds it took for the transactions to occur. Retail is also a significant industry in New York, with many domestic and international retail companies headquartered in the city. Health care, mostly because of the sheer amount of people who live there, is one of the fastest growing and largest industries in the city. Professional and Technical services, such as law firms and accounting firms, also make up a significant portion of jobs; this should be expected because the large amount of businesses located in New York City need support services.

## **Healthcare**

Being one of the largest cities in the country, New York City has some of the best hospitals and healthcare. It has three hospitals in the top twenty hospitals in the United States, according to U.S. News.

Charlotte has two of North Carolina's top twenty hospitals; however, there are many respectable teaching hospitals in the state to compete with. Carolinas Medical Center is ranked in the top fifty in one adult specialty, orthopedics. It also ranks in the top fifty for six pediatric specialties: cancer, cardiology, gastroenterology, nephrology, neurology, orthopedics, neonatology, endocrinology, pulmonology, and urology.

## **Crime**

Common types of crime in New York are robbery, theft, and burglary; however, these can be avoided by staying away from certain areas of the city. South Bronx, in Brooklyn, and the Chelsea Hell's Kitchen area should be avoided, due to the high rate of crime in these areas.

The majority of crime in Charlotte is property crime, similar to most large urban areas. There are a few areas to avoid include Westover Hills, Pinecrest, and Arbor Glen. However, there are many great neighborhoods in and around Charlotte that make up for some of the dangerous areas.

## **Rent**

If I move to New York, I would like to live in Manhattan for at least a few years. So that I can have relatively affordable rent, I have chosen to live in either the East Village or Midtown. Also, roommates are almost a necessity in New York. Rent, with three other roommates, will be somewhere between \$1000 and \$1500. Square feet is not listed in many of the listings on Zillow for New York, but it can be assumed that it is fairly small compared to other Oxford and other cities. There is no parking included with the apartment, but I would not bring a car if I move to New York. There is laundry in both of these apartments, which is definitely a plus.

Rent in Charlotte, with one or two roommates, is between seven hundred and a thousand dollars. Living in the downtown area is fairly expensive to some of the suburbs; however, it provides more nightlife opportunities and shorter commutes. Most of the homes and apartments are around 1500 square feet, with parking spots included in rent. Many apartments have pools, gyms, and other additional amenities; the houses in the downtown area generally do not have off street parking.

## **Transportation**

Most people in Charlotte area drive to work; there is not a subway or metro system. However, depending on where I choose live, it is possible to walk to work within the downtown area. This would largely depend on if my future employer's building has parking spots available or not. If I chose to live in the places listed above, I could walk to most places downtown in under twenty minutes, or drive in under fifteen minutes.

The subway system is the most common type of commuting within the city, but this could be supplemented with taxi's or a ride sharing service when necessary.

## **Grocery Stores**

In New York City, there are plenty of grocery stores in the area, some within walking distance. There are also grocery delivery services, which is revolutionary to someone who has lived in the non-urban south for all of his life.

There are many grocery stores in the Charlotte downtown area; grocery delivery would not be required. There is a Harris Teeter located down the street from my selected apartments, and a Whole Foods within ten minutes of driving.

## **Laundry**

Some apartments have washer and dryers in the unit, others have them in the building, and others do not have them at all. If washer and dryers are not located in the building or unit itself, I could send my laundry away to get washed.

In Charlotte, laundry will be done in my apartment or house; it is common for Charlotte residences to have washer and dryers included.

## **Volunteer Opportunities**

If I lived in New York, I would love to volunteer at or assist St. Jude in any way that I could if possible. While in high school, I was active in the local Young Life organization. If I could find a way to assist them in any accounting capacity, I would love to use the skills that I have learned at Ole Miss to give back to the organization that I loved while in high school. In New York City, there is an organization called East Harlem Tutorial Program. Within this organization, the College Mentoring Program assists students in the college application process, which can be fairly complicated. A one-on-one relationship is created between mentors and high school students for two years, and in the student's senior year of high school assists in applications for colleges and scholarships. The second year consists of virtual meetings, over the phone or through FaceTime or Skype, to guide the student through the first year of college. The college application process was foreign to me as a high school student, as I was the oldest sibling in my family and my parents had not been through the process in decades. I have loved helping my younger brother, who is currently a senior in high school, navigate through the process over the past year. I would have greatly appreciated a current or recently graduated college student to assist me in the process. St. Peter's Episcopal, the church that I was baptized in, and my parents got married in, is located

in downtown Charlotte. If I lived in Charlotte, I would want to be active in their current missions and programs.

### **Things To Do For Fun**

Charlotte is home to the Carolina Panthers and Charlotte Hornets, two professional football and basketball teams, respectively. I would love to be a frequent attendee to both teams' games. Lake Norman is located to the north of Charlotte, and it has many active yacht clubs that I would plan on joining. The Fillmore is a music venue that hosts a variety of genres of bands and artists, despite it being standing room only. It is not an exceptionally large venue, which is quite attractive to me due to the intimate atmosphere it creates. The Outer Banks, located on the Atlantic coast of North Carolina boast some of the best scuba diving in the United States. I have been scuba diving since I was twelve years old, and would love to be able to dive as frequent as I can. Even though it is more than six hours away, it is still a drivable distance for a long weekend vacation.

New York has eleven major sports teams located in the metropolitan area, spanning baseball, basketball, hockey, football, and soccer. Madison Square Garden is located in Manhattan, which hosts countless events every year. In addition to Madison Square Garden, New York has the Barclays Center and many other venues for concerts. I would love to attend a Yankees versus Red Sox game, especially since my father was born in Boston. Growing up on the coast of Mississippi, most concert tours do not perform near my hometown, and if they do, the nearest large venue is at least an hour away. Madison Square Garden attracts many famous bands and artists, which would be a great experience. The bar and restaurant scene in New York is some of the best in the country, and I have not gone to a true five-star restaurant before. Eating a place like that is

definitely on my New York bucket list. Also, while not necessarily in the city, the far northeast United States has decent skiing, and being relatively close to ski slopes, compared to Mississippi, is something that I would enjoy. I have recently come to appreciate standup comedians, and I would love to go to the Comedy Cellar, even if it is not for a major comedian.

### **Traveling Home**

In order to travel from New York to my hometown, Ocean Springs, Mississippi, I would have to fly. It is almost a twenty-hour drive, and I would not have a car in New York to drive. A flight from any of the airports in New York to Gulfport, the closest airport to my hometown, is about four to five hundred dollars. This rate would most likely change depending on the time of year, and how far in advance flights are booked.

The drive from Charlotte to Ocean Springs is about nine hours, which is a little long to drive; however, it could be done if I needed too. In my current vehicle, it would cost about \$270 in gas to drive. Flights from Charlotte to Gulfport can be found for around the same price, so time would be the deciding factor on my transportation method.

## Budget

### New York

Salary	\$60,000
Federal Tax	\$(9,145)
City Tax	\$(2,202)
State Tax	\$(3,533)
Health Insurance	\$(2,409)
Annual Income	\$42,711
Income per Month	\$3,559
Rent	\$(1,250)
Unlimited Subway Card	\$(121)
Utilities(estimated)	\$(150)
Groceries	\$(800)
Renters Insurance	\$(25)
Taxi/Uber	\$(200)
Cell Phone	\$(80)
Netflix/Spotify/HBO/Amazon	\$(45)
Clothing	\$(300)
Extra Spending/Retirement	\$588

### Charlotte

Salary	\$60,000.00
Federal Tax	\$(9,145.00)
State Tax	\$(2,750.00)
Health Insurance	\$2,409.00
Annual Income	\$50,514.00
Income per Month	\$4,209.50
Rent	\$(800.00)
Gas	\$(270.00)
Utilities(estimated)	\$(100.00)
Groceries	\$(600.00)
Renters Insurance	\$(25.00)
Car Insurance	\$(100.00)
Cell Phone	\$(80.00)
Netflix/Spotify/HBO/Amazon	\$(45.00)
Clothing	\$(300.00)
Car Payment	\$(500.00)
Extra Spending/Retirement	\$1,389.50



## **Conclusion**

Based on my research, I would still want to live in both of these cities. A lot of my family live in Charlotte, and I enjoy the city and its surrounding areas. It is a major city, with a lot of growth and a variety of industries. It is also a significantly cheaper place to live than New York City. However, the career opportunities and personal experiences that New York has to offer greatly outweighs the cost of living. These places are also not where I have to live for the rest of my life, and I think that living in New York City would be a great learning experience, in regards to both my career and life.

## **What I Learned**

This case taught me, most importantly, the high cost of living in large cities. It also showed me how much thought needs to go into where I choose to live. There are many things to consider besides the type of job when moving, especially to a completely foreign place.

## Case 6

WorldCom Inc.

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## **Explanation of Assets and Expenses**

The difference between assets and expenses is that future economic benefits are a result of assets. Expenses are costs that come from outflows from business operations or costs associated with liabilities, i.e. interest.

## **Expensing vs. Capitalizing Costs**

Costs should be expensed when the costs are associated with the current operation of the business. Costs should be capitalized as assets when, in the future, revenues will be incurred because of them.

## **Effect of Capitalization**

Once costs are capitalized, they become assets on the balance sheet. When costs are paid using cash, cash is credited and an asset account is debited. Only the assets section will be affected when this occurs. The income statement is not affected; however, if the costs were expensed, they would be stated as an expense in the income statement and therefore would negatively affect net income.

### **Line Costs Journal Entry**

Line Costs	35,179,000,000
Cash	35,179,000,000

These line costs seem to be the costs associated with the use of third party network's telecommunications equipment.

### **Transaction Evaluation**

The costs improperly capitalized were charges paid to third party networks to complete calls. WorldCom had to pay to use other companies' networks; this was one of their largest expenses. So, instead of documenting these as expenses, they capitalized them as assets. Because paying other companies to use their networks does not facilitate future economic benefits or cash flows, these costs do not meet my definition of an asset.

### **Corrected Journal Entry**

Transmission Equipment	3,055,000,000
Cash	3,055,000,000

These costs appeared as Transmission Equipment on the balance sheet. WorldCom most likely chose this because if they were using their own equipment, this is where the costs would appear. On the statement of cash flows, these costs would appear in the investment section, where purchase and sales of assets are.

## **Depreciation Evaluation**

The depreciation expense for 2001 is \$35.045 million for the first quarter, \$20.795 million for the second quarter, \$16.886 million for the third quarter, and \$10.579 million for the fourth quarter. Total depreciation expense for 2001 is \$83.306 million.

## **Corrected Net Income Calculation**

Had WorldCom correctly expensed the line costs, they would have had a net loss of \$1.470 million. Because this is almost a three-billion-dollar difference in net income, this is material.

## **What I Learned**

This case taught me that fraud is a possibility in almost every company, whether it be large scale fraud, as in WorldCom, or small scale, which is probably much more common. The pressure that analysts put on companies, and the pressure that companies place on executives in the form of bonuses and compensation, is not something to underestimate when working as an accountant in industry or as an auditor. Managing earnings, especially when earnings is a large factor in determining your compensation, is a large problem in the way corporations are currently run. Executives must be vetted to ensure that they haven't had any ethical issues in the past, so that there are none in the future.

## Case 7

# Starbucks Corporation

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## **Executive Summary**

This case is essentially about financial statement analysis of Starbucks Corporation in 2013, using some 2012 data as a comparison. It mostly focuses on things such as stored value cards and litigation's effect on the bottom line. It analyzed many differences between 2013 and 2012, which helps understand what account values should be and if there were any transactions that were specific to a certain year.

Throughout this case, I learned how to navigate and analyze financial statements of large publicly traded corporations. I came to realize how companies recognize revenue across different service lines and subsidiaries, and also how auditors formally issue their opinion on a company. Common size income statements were new to me before starting this case, but I can now see their usefulness in comparing prior periods financial statements to the current period. This was a thorough case study that gave me experience in navigating all sections of a 10-K report.

## **Overview of Starbucks**

Starbucks is a retailer and distributor of coffee, tea, and related products. In their retail stores, they sell an assortment of tea and coffee products. They also have coffee, ground and whole bean, sold in many large grocery and big box stores. They make money through corporately owned stores, licensed stores, and the sales from grocery and big box stores.

## **Typical Financial Statements**

The normal financial statements used for public company reporting are the balance sheet, income statement, statement of cash flows, and statement of shareholder's equity. Starbucks calls these financial statements consolidated balance sheets, consolidated statements of earnings,

consolidated statement of cash flows, and consolidated statements of equity. Starbucks also includes a statement of consolidated comprehensive income, which contains other non-Generally Accepted Accounting Principles (GAAP) forms of income. Consolidated means that the statements also include the financial information from the company's subsidiaries.

### **Frequency of Financial Statements**

Publicly traded corporations prepare financial statements 4 times a year, at the end of every quarter.

### **Users of Financial Statements**

The management of a corporation is responsible for preparing the financial statements each quarter, and the Chief Executive Officer and Chief Financial Officer must personally sign them to corroborate the internal controls of the company. Users of the financial statements include the management of the company, investors, and creditors. One could also argue that the Securities and Exchange Committee is a user of the financial statements.

### **External Auditors**

Starbucks's external auditors are Deloitte & Touche, LLP (Deloitte). The first letter states that Deloitte has audited Starbucks's financial statements and that they fairly represent Starbucks's financial situation. It also states that Deloitte expresses an "unqualified opinion on the Company's internal control over financial reporting." The second letter states that Deloitte has audited the internal controls of the company and that Deloitte has the opinion that Starbucks has adequate internal control over their financial reporting. It also states that Deloitte's report

expresses “an unqualified opinion” on Starbucks’s financial statements. In this situation, “unqualified opinion” means that there are no material mistakes in the financial statements, that these financial statements are accurate in regards to the company’s financial accounts, and that Starbucks’s internal controls over their financial reporting are adequate. These opinions were released a few months after the financial year end because it takes time to conduct an audit effectively.

### Common Sized Financial Statements

#### Balance Sheet:

<b>Current assets:</b>	<b>2013</b>	<b>2012</b>
Cash and cash equivalents	22.36%	14.46%
Short-term investments	5.71%	10.32%
Accounts receivable, net	4.87%	5.91%
Inventories	9.65%	15.10%
Prepaid expenses and other current assets	2.50%	2.39%
Deferred income taxes, net	2.41%	2.90%
<b>Total current assets</b>	<b>47.51%</b>	<b>51.09%</b>
Long-term investments	0.51%	1.41%
Equity and cost investments	4.31%	5.60%
Property, plant and equipment, net	27.79%	32.35%
Deferred income taxes, net	8.40%	1.18%
Other assets	1.61%	1.76%
Other intangible assets	2.39%	1.75%

Balance Sheet:

Goodwill	7.49%	4.86%
<b>TOTAL ASSETS</b>	<b>100.00%</b>	<b>100.00%</b>
<b>Current liabilities:</b>		
Accounts payable	4.27%	4.84%
Accrued litigation charge	24.17%	0.00%
Accrued liabilities	11.02%	13.79%
Insurance reserves	1.55%	2.04%
Deferred revenue	5.68%	6.21%
<b>Total current liabilities</b>	<b>46.69%</b>	<b>26.89%</b>
Long-term debt	11.28%	6.69%
Other long-term liabilities	3.11%	4.20%
Total liabilities	61.08%	37.77%
<b>Shareholders' equity:</b>		
Common stock (\$0.001 par value) - authorized, 1,200.0 shares; issued and outstanding, 753.2 and 749.3 shares (includes 3.4 common stock units), respectively	0.0069%	0.0085%
Additional paid-in capital	2.45%	0.48%
Retained earnings	35.86%	61.40%

Accumulated other comprehensive		
income	0.58%	0.28%
Total shareholders' equity	38.90%	62.16%
Noncontrolling interests	0.0182%	0.0669%
<b>Total equity</b>	<b>38.92%</b>	<b>62.23%</b>
<b>TOTAL LIABILITIES AND EQUITY</b>	<b>100.00%</b>	<b>100.00%</b>

Income Statement:

<b>Net revenues:</b>	<b>2013</b>	<b>2012</b>
Company-operated stores	79.19%	79.21%
Licensed stores	9.14%	9.10%
CPG, foodservice and other	11.67%	11.69%
<b>Total net revenues</b>	<b>100.00%</b>	<b>100.00%</b>
Cost of sales including occupancy costs	42.86%	43.71%
Store operating expenses	28.78%	29.46%
Other operating expenses	3.07%	3.23%
Depreciation and amortization expenses	4.17%	4.14%
General and administrative expenses	6.30%	6.02%
Litigation charge	18.70%	0.00%
Total operating expenses	103.87%	86.57%
Gain on sale of properties	0.00%	0.00%
Income from equity investees	1.69%	1.58%
<b>Operating income</b>	<b>-2.19%</b>	<b>15.02%</b>

#### Income Statement:

Interest income and other, net	0.83%	0.71%
Interest expense	-0.19%	-0.25%
<b>Earnings before income taxes</b>	<b>-1.54%</b>	<b>15.48%</b>
Income taxes	-1.60%	5.07%
<b>Net earnings including noncontrolling interests</b>	<b>0.06%</b>	<b>10.41%</b>
<b>Net earnings attributable to noncontrolling interest</b>	<b>0.00336%</b>	<b>0.00677%</b>
<b>Net earnings attributable to Starbucks</b>	<b>0.06%</b>	<b>10.40%</b>
Earnings per share - basic	0.00007%	0.01376%
Earnings per share - diluted	0.00007%	0.01346%
<b>Weighted average shares outstanding:</b>		
Basic	5.03%	5.67%
Diluted	5.12%	5.81%
Cash dividends declared per share	0.01%	0.01%

#### Balance Sheet Analysis

Both total assets and total liabilities and equity are equal to 100%, therefore the accounting equation holds for this situation.

Starbucks's major assets are the following: property, plant, and equipment; cash and cash equivalents; and inventories. The percentages are 27.79%, 22.36%, and 9.65% respectively.

Short term assets make up 47.51% of total assets and long term assets make up 52.49% of total assets.

Intangible assets are usually divided into two categories, definite life and indefinite life. Definite life intangibles include acquired rights, trade secrets, contract based patents, and copyrights. Indefinite life intangibles include trade names and trademarks with indefinite lives, and goodwill.

Starbucks is primarily financed through debt, with total liabilities coming out to \$7,034,400. Starbucks's total shareholders' equity is \$4,480,200,000.

### **Statement of Earnings Analysis**

Starbucks recognizes revenues, in general, when customers pay for their products at the point of sale. Starbucks's revenues from prepackaged goods are recorded net of sales discounts, and they are recorded when the products are received by the customer or distributor. It seems that Starbucks uses both cash basis and accrual accounting, depending on what service line the revenues come from. Starbucks records revenue from gift cards when they are redeemed, or when the gift cards are unlikely to be redeemed. Management is in charge of deciding when a gift card is unlikely to be redeemed.

Store operating expenses and cost of sales including occupancy costs are two of the largest expenses in 2013. There is also a litigation charge on Starbucks's consolidated statement of earnings; however, this would probably be a one-time expense due to a lawsuit occurring in that year.

There was a litigation expense that is one of the main reasons for an operating loss in 2013. The total amount for this expense is \$2,784,100,000.

Because this litigation expense is material and such a large amount, it must be presented separately from other expenses, for example general and administrative expense. It is classified

as an operating expense because this litigation charge must have been related to the company's main activity.

Starbucks was profitable in both 2012 and 2013; however, the only reason it was profitable in 2013 was due to interest income. Profitable means, to me, that at the end of the period, there is not a net loss.

### **Statement of Cash Flows Analysis**

Starbucks's net cash provided by operating activities is \$2,908,300,000, and Starbucks's net earnings is \$8,800,000. This difference can most likely be attributed to the litigation expense in 2013.

Starbucks used \$1,151,200,000 for property, plant, and equipment in fiscal year 2013.

Starbucks paid \$628,900,000 in dividends, and declared \$668,600,000 in dividends during 2013. They declared more than they actually paid, but this is not uncommon as these dividends may be paid in early 2014.

### **Estimates Used in the Financial Statements**

Accounts that require estimates include: asset and goodwill impairment, stock-based compensation forfeiture rates, future asset retirement obligations, inventory reserves, and income from unredeemed stored value cards. Accumulated depreciation could also be included as an account that requires estimating. The historical cost principle allows companies to not estimate most asset accounts because companies must report them at the acquisition cost.



## Case 8

### BP p.l.c. – Contingencies

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## **Executive Summary**

This case was focused around contingent liabilities and how they should be estimated and accounted for. It discussed BP's situation due to the oil spill and how large mistakes can affect a corporation's financial statements and accounting procedures.

Though this case specifically focused on BP and the oil spill, I learned that major corporations must be careful to avoid mistakes. Not only can a mistake affect their public image, but they can also affect the bottom line of the corporation. It also seemed that the Financial Accounting Standards Board (FASB) has very liberal rules on accounting for contingent liabilities. There should be more guidelines on how to interpret the word "probable". Perhaps if the amount of the contingent liability exceeds a specified amount or percentage of revenue, there should be a different set of rules. Overall, this case exposed me to how corporations handle events such as oil spills or large scandals, and makes me wonder if there are any case studies about the Volkswagen diesel emissions scandal.

## **Contingent Liability Definition**

A contingent liability occurs when a company might be required to pay someone, or another company, in the future. These most often occur as a result of lawsuits; however, ongoing investigations and product warranties can also cause contingent liabilities. Companies should record contingent liabilities when the amount is able to be estimated and it is probable that the company will have to pay it. Companies do not record contingent assets because that would not be in accordance with the conservatism principle.

### **Telescopic Joint, Warranty or Contingency?**

In this situation, BP would consider this a contingent asset. If the telescopic joint fails, they would not have to purchase another one. BP does not record the warranty. GE Oil and Gas would record the portion of this that is probable and estimable as a contingent liability and disclose the remaining portion in the footnotes to the financial statements.

### **Management's Judgement of Contingencies**

Management would have to judge how likely the loss is to occur, and how much the loss would be. In the case of warranties, management would have to determine how many products will be returned or repaired and what cost would be incurred because of product returns or repair. Warranty claims on equipment or products can be relatively easy to estimate because there is most likely historical information about returns and repairs on products that have been sold in the past. A claim for damages relating to an oil spill would be much harder to estimate. First of all, these claims must be made through lawsuits. Lawsuits can be unpredictable, and, for the most part, are unique. It can sometimes be hard to use precedence to estimate damages. Second of all, oil spills have their own characteristics that are different from other events that can cause damages. They can have lasting impacts that are extremely hard to predict. They are not a common occurrence, which makes it difficult to use past events to estimate damages.

## **Responsibility for Damages**

As an auditor, it would be extremely difficult to draw a boundary around the losses associated with the oil spill. They would have to examine prior companies' treatment of oil spill damages to see how others have treated the losses in their financial statements. Auditors should also speak with lawyers familiar with the topic to attempt to estimate the loss so that it can be compared with BP's reported loss. Lawsuits that are frivolous in nature and unlikely to end in damages being paid should be ignored, as should anything that was not directly caused by the oil spill. A thorough analyzation of past lawsuits and current laws should be done to estimate the loss as accurately as possible. However, it may not be the auditors job to draw a boundary around the losses, therefore limiting the loss. It should be the auditors job to determine if the loss is as accurate as possible.

BP has several types of damages that must be paid. BP has separated these claims into two main categories, economic and property claims (E&P) and medical claims. Within E&P claims there are many different types. First, there are subsistence claims. These are claims made by people who utilize the fisheries to feed themselves and their families. Second, there are claims made by businesses who lost revenue because of the oil spill. These include commercial fishermen, charter fishermen, and almost any business related to tourism on the Gulf Coast. Third, there are property damage claims. These are claims related to coastal property being damaged because of the oil spill. Finally, there are claims related to damage inflicted on boats and ships due to the oil spill. Medical claims can be made by people who live near the water and were harmed by the oil spill and people who assisted in the cleanup process and were harmed by the oil spill.

BP should be responsible for their portion of the damages. There were two other companies involved, Halliburton and Transocean. Halliburton is an extremely large oil and gas corporation and Transocean is the company that was operating the rig. These three companies should be held proportionately responsible for the damages. Also, if BP is not held responsible, then who or what entity should be? There was and is significant damage to the Gulf Coast and its fisheries, and the environment should be returned to its original condition or as close as possible.

## Case 9

### The Wendy's Company – Equity Method Investments

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## **Executive Summary**

This case was about accounting for investments using the equity method, and specifically when the amount of voting stock owned approaches fifty percent of the total amount of voting stock. It discussed specifically how it affects the investor's income statement, in both loss and income situations.

One of the most important things I learned while completing this case is that the difference between the purchase price and book value of the stock is not always recorded as goodwill. This amount is sometimes used to do other things, like write up certain assets. It also showed me that joint ventures area accounted for as if they are investments.

## **Overview of Joint Venture**

Companies enter into joint-ventures to gain an advantage from other companies' resources. It distributes the risk between the two companies while allowing expertise to exchange to compete better against others. It can also sometimes be used as a tax advantage, and in this case the two companies could create an entire separate legal entity.

## **Explanation of Equity Method**

Companies can account for investments in three different ways, depending on the percentage of voting stock they hold in the investee and the amount of control that they have over the investee. The equity method is used when twenty to fifty percent of a company's voting stock is owned by another company or firm that has significant influence over the investee. When a company purchases the stock, the increase the investment account. The investment account is increased when the investee reports net income, and it is decreased when the investee

reports a net loss. When cash dividends are paid, the investment account is decreased. This method is used because the stock is treated more as ownership in a company than an investment. Dividends cost money to pay, so that is why they decrease the investment account. If the fair value method was used, dividends would be treated as income, when really they are not.

### **Equity Method Account Balances**

In 2012, Wendy's equity investments totaled approximately 87.620 million dollars. This consisted of an 89.730 million dollar investment in the joint venture with THI, as well as the investment in the Japan Joint Venture. The Japan Joint Venture Account had a credit balance of about 1.75 million dollars. The investment in THI is included in the investments account on the consolidated balance sheet and the investment in the Japan JV is included in other liabilities. In 2011, Wendy's equity investments totaled approximately 91.819 million dollars. This consisted of about a 91.742 million dollar investment in the joint venture with THI and a 77 thousand dollar investment in the Japan JV. These investments were both included in the investments account on the Wendy's consolidated balance sheet. Earnings and losses due to these investments are included in other operating expense on the income statement.

### **Investment Account Differences**

TimWen records partner's equity at approximately 70.565 million dollars, so Wendy's portion of that is about 35.283 million dollars. Wendy's reported about 89.730 million dollars as their investment in TimWen. The difference, around 54.447 million dollars, can be attributed to AAP.

### **TimWen Joint Venture Analysis**

Wendy's equity method investments income were approximately 13.680 million dollars in 2012 and approximately 13.505 million dollars in 2011. These investments appear on the income statement as other operating expenses.

Equity Investment	13,680
Equity Income	13,680
Loss in investment	3,129
Equity Investment	3,129

Wendy's received approximately 15.274 million dollars in dividends from TimWen.

### **Statement of Cash Flow Analysis**

A negative adjustment is made because that is income related to a joint venture investment's operations, and is related to Wendy's investment activities. A positive adjustment is made because dividends received is recorded as an operating activity, and is not included in any other line item on the cash flow.

## Case 10

### Johnson & Johnson – Retirement Obligations

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## Types of Retirement Plans

In a defined benefit plan, an employee receives compensation when they retire based on how many years they worked at the company and what their salary was. In a defined contribution plan, employees contribute to their retirement plan, usually a 401(k), and the employer usually matches up to a certain amount. Johnson and Johnson uses both defined contribution and defined benefit plans, but mostly defined benefit plans.



When a company accounts for a retirement plan, companies must assume certain things about employees. They must assume or estimate how long the employee will work, and what their salary will be. Once the employee retires, they must also assume or estimate what how long they will live. Actuaries usually perform this type of estimating.

## Four Pension Asset Activities

Service cost is what the employees earned towards their plan for working another year. Interest costs occur because the pension obligation is a liability, and therefore incurs interest. Actuarial gains or losses arise from changes in the predictions or new predictions that the

actuaries make in regards to some of the assumptions mentioned above. The benefits paid to employees are how much the company had to pay to former retired employees that year.

### **Three Pension Asset Obligations**

The actual return on assets is determined by how much the retirement plan assets have grown over the past year. Contributions to the retirement plan are how much the company paid into the plan throughout the year. The benefits paid to employees are how much the company had to pay to former retired employees that year.

### **Return On Plan Assets**

One of these returns is the expected return on plan asset that the company predicts at the beginning of the period. The other return is the difference between the expected return and the actual difference in plan assets between the beginning of the period and the end of the period. These two different returns are used to see how well the company predicted the actual return of the retirement plan assets.

### **Difference Between Benefit Plans**

Retirement plan benefits are funded in advance, while the other benefits Johnson & Johnson provides are not funded while the employee is working. The other benefits provided are expensed as the costs are incurred, and the terms of these benefits can also be modified, unlike retirement plans.

### **Pension Expense Details**

Johnson & Johnson reported approximately 646 million dollars of pension expense in 2007.

Annual Pension Expense	1,253
Service Cost	597
Interest Cost	656

### **Pension Liability Details**

The value of the projected benefit obligation is approximately 12,002 million dollars at the end of 2007. This number is as reliable as it can be, due to the actuarial assumptions that must be made to get this number.

Interest cost for the year is approximately 656 million dollars. The average interest rate is 5.6 percent. To see if this is reasonable, this should be compared to other companies' percentage rates or current market rates.

Approximately 481 million dollars of benefits were paid to retirees. These payments were paid for using the prior contributions into the plan, not cash. Benefits paid decrease the planned benefit obligation and the plan assets.

### **Pension Plan Assets**

The fair value of the plan assets are approximately 10,469 dollars. This represents the fair value of the investment instruments in the retirement plan fund.

The expected return for 2006 and 2007 is 701 million dollars and 809 million, and the actual return is 966 million and 743 million, respectively. The difference in 2007 is not



significant, but the difference in 2006 is fairly large at 255 million dollars. The actual return on plan assets is a better measurement of the return. The expected return is an estimated value and is not as good a measurement.

In 2007, 317 million dollars were contributed by Johnson & Johnson, and 62 million dollars were contributed by the employees. In 2006, 259 million dollars were contributed by Johnson & Johnson, and 47 million dollars were contributed by the employees.

For United States retirement plans, 79 percent of the investments are equity investments, and 21 percent are debt securities.

#### **Funding Level of Retirement Plan**

At the end of 2007, Johnson & Johnson's retirement plan was underfunded by 1,533 million dollars. At the end of 2006, they were underfunded by 2,122 million dollars. These amounts are reported in Note 13 on the 10-K of Johnson & Johnson.

## Case 11

### Balance Sheet Approach vs. Income Statement Approach

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## **Background Information**

This paper focuses on some of the issues associated with using the balance sheet approach of accounting. The balance sheet approach has been adopted by many standard setting organizations, especially once the Financial Accounting Standards Board (FASB) chose it in the late 1970's. On page six of the paper, Dichev says that the FASB narrowed it down to the income statement and the balance sheet methods. He also explains that the FASB decided that in order to "ensure conceptual clarity" a method had to be chosen, and that a "muddled compromise" would not be a viable option. Essentially, the balance sheet approach views the valuation of assets and liabilities as the purpose of financial reporting, while the income statement approach views the valuation of revenues and expenses as the purpose of financial reporting. Dichev goes on to say that because many of the authors of accounting books in the mid to early 1900's were proponents of the income statement approach; it was the dominant method until the 1970's. The FASB chose the balance sheet approach because they believed that income and earnings is based off of "changes in value," and changes in value cannot be determined until value can be defined. Therefore, measuring the value of assets and liabilities must be logically before measuring earnings. The income statement approach, according to FASB is unreliable due to the concept of matching revenues and expenses. Since the adoption of the balance sheet approach, the FASB has changed older rules and regulations to conform to the balance sheet approach (page 6). Many international accounting organizations have also adopted the balance sheet approach, and it is now the prevalent method used around the world. FASB, more recently, has published how they feel about the current Conceptual Framework and that they intend to eventually create a joint framework or collection of standards.

## **Critique of Balance Sheet Approach**

Dichev begins his critique by stating that the balance sheet approach should not be used because it conflicts with how most businesses are run. On page 10, he explains that firms, at their core, are conduits for managing expenses, to potentially create earnings. Based on this statement, the only purpose assets serve is to earn revenue. They are essentially consumed through depreciation and are rarely kept in order to produce revenue based on their sale. Investment firms are one of the few examples where assets are used for this purpose. Dichev also states that, “The firm is a process and not a collection of “things,” implying that the income statement model is the natural foundation for financial reporting” (page 12). This sentence clearly summarizes Dichev’s views on this topic, arguing that assets are usually fairly insignificant when it comes to how a firm’s actual business processes.

His second main point regarding the pitfalls of the balance sheet approach is that the income statement approach is the superior method. He argues that because the FASB’s definition of an asset uses the concept of earnings, the income statement approach must be the better method for financial reporting. He states, “... the concept of asset and income are inextricably connected” (page 15). Generally, assets produce income through their use and consumption, but there is little use unless the asset can produce income. However, on the next page, he says that most assets today are fairly hard to “operationalize” (page 16). His statements above are a great example of why this discussion is needed in the current accounting environment.

Dichev’s third point is that the balance sheet approach is a major reason why the usefulness of earnings is declining (page 16). The logic behind this point relies on the assumption that investors are the primary users of financial statements. Balance sheet accounting, which in the most extreme form is mark-to-market accounting, relies on the

unpredictable market values of assets and liabilities (page 17). Essentially, this means that earnings are useless because of the constantly changing market. This has driven investors to calculate their own earnings, which are not in accordance to the standards in place. He argues that the increase in popularity of non-GAAP measures of earnings questions the utility of the accounting system, and that there are serious problems with using pro forma earnings as a measurement.

The final point in the paper is that many problems occur when the balance sheet method is used. Enron used this approach extensively to manage earnings and manipulate their financial information. Dichev says that extreme mark-to-market accounting can “create a feedback loop between financial markets and the real economy, and may possibly lead to or exacerbate bubbles” (page 19). He argues against the accuracy of financial markets, which the balance sheet approach uses extensively, and that the financial markets do not portray the state of the real economy at all.

### **Suggestions for a New Approach**

Dichev’s next section of his paper discusses what a better model would look like. He believes that there should be a separation of financing and operating activities, so that the balance sheet method may be used in some situations and the income statement method be used in other situations. He also thinks that there should be a larger emphasis on the matching principle and revenue recognition process. Currently, the FASB and International Accounting Standards Board (IASB) disregard the concept of matching. Dichev believes that it “should be the cornerstone of financial reporting,” and that all other concepts are unacceptable (page 23).

### **How did reading this article change your way of thinking?**

As my education in accounting has progressed, I have realized that there is much more grey area than I originally thought in the practice of accounting. This article has solidified this realization even more. Deciding between these two methods is an extremely difficult endeavor. The FASB had to pick one, and I am sure that they picked the method that they believed was the best at the time.

I never realized that there were two main approaches to accounting, and that many people have a significant amount of animosity towards each method. Dichev presents many great points against the balance sheet approach; however, I am sure that there is someone that has as many great points against the income statement approach. I am usually wary of changing my mind when I have only heard one side of the situation, and therefore my way of thinking has not necessarily changed. I am more aware of these ideas, and can use them throughout the rest of my education, but I would not say that the process and logic behind my thinking has changed. It seems to me that it does not actually matter which approach is chosen; the income statement approach most likely has as many flaws as the balance sheet approach does. I think consistency should be the main focus of the FASB's standard setting objectives, so that users of financial statements can easily compare companies. But, if investors are already using their own non-GAAP measures of earnings, I do not think they will trust a brand new way of valuing earnings.

This paper did allow me to better understand the difficult task the FASB must complete. Developing a joint collection of standards with the IASB will be extremely difficult, especially with the large number of parties that will be drastically affected by it. I am not sure why the FASB and IASB want to combine their standard setting procedures. The size of the United States economy is large enough that there is no need to join forces with other standard setting

organizations. While it may be useful to some people, many companies in the world operate in the United States and must at least adhere to GAAP regulations.

Overall, this paper has given me some thought provoking ideas to contemplate. I do not think I have ever thought this much about the reasoning behind accounting methodologies, but I can see the usefulness in fully understanding the reasoning behind the FASB's standards.

### **How will you use this information in your future career?**

I will be able to use the knowledge learned from this paper almost every day in my future career. To understand how a business operates, I must first understand accounting. Different accounting methods have extreme effects on a business, for example, companies must choose which type of inventory method to use. I hope to one day own and run a large company, and in order to do this, I must first understand the logic behind the accounting methods.

I will be working at a large international accounting firm for the first few years of my career, where I will most likely be auditing companies' financial statements. When examining financial statements, it is imperative that I have a deep understanding of the accounting presented in them. I also would like to work as a consultant that implements large accounting systems for corporations. I will need to have a grasp on the logic and reasoning behind the FASB's decisions, and how they affect my current project.

This information can be used in almost any career in a large corporation, no matter the industry or area in which it operates. This is a great example of why I think that everybody should have at least a fundamental understanding of accounting, so that they can truly comprehend how a firm operates.



## **Bibliography**

Dichev, Ilia D., On the Balance-Sheet Based Model of Financial Reporting (August 2007).

## Case 12

# Google Inc. Earnings Announcements and Information Environment

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## **What I Learned**

This case taught me how important revenue and earnings are when it comes to a company's stock performance. Revenue recognition can be very problematic for some companies, and a transaction that happens only a few days late can have significant consequences depending on how large the transaction is. Wall Street places entirely too much importance on how a company performs compared to analyst's predictions, especially when the predictions are most likely made with minimal information compared to how much information executives have. It makes me wonder why companies are so secure with most of their cutting edge work, when it could drive the stock price up. Because many executives' compensation is based on stock performance, Wall Street's reactions have pressured many executives into managing earnings, a serious problem in today's accounting profession. In conclusion, it seems that this case showed me how much influence Wall Street has on a company's actions.

## **What the Case is About**

This case covered many important topics facing the accounting industry today, such as pro-forma earnings and stock price analyzation. Non-GAAP earnings are calculated by omitting certain items from net income to achieve a "more accurate" measurement of a company's performance, but this is not always the case. I examined items that should and should not be included in non-GAAP earnings, and justified both sides. I also compared a *Wall Street Journal* article's reaction to Google's fourth quarter earnings, and decided if the article was in agreement with the market or not.

## **Adjustments to Reach Non-GAAP Earnings**

One of the large adjustments Google made to compute non-GAAP results of operations is the elimination of stock based compensation expenses. Google also eliminated restructuring and related charges. Because of these two adjustments, they also had to take into account the tax effects for both of these items. The last adjustment made is the elimination of the net loss from discontinued operations. I agree with the first few adjustments; however, I think a loss from discontinued operations should be included when calculating earnings of any type. Omitting that loss does not fairly represent how the firm performed. The consequence of a poor business decision should be reflected in earnings, even if it is a form of non-GAAP earnings.

## **Stock Market Charts Analysis**

As is usual in publicly traded companies, when quarterly earnings are released, stock prices are affected. The largest increase in stock price happened just after the third quarter earnings were released; the stock price jumped about a hundred dollars. Overall, even though Google's earnings were barely in line with what the analysts predicted, the stock price rose over four hundred dollars throughout the year.

Google's stock price did much better than the NASDAQ in 2013. There are a few dips in the stock price that are not reflected in the NASDAQ index, such as at the beginning of February. There was also an increase in Google's stock price around the end of May and beginning of June that is not reflected in the NASDAQ index. The sharp rise of Google's stock price after the third quarter does not occur in the rest of the firms trading on the NASDAQ. Overall, the NASDAQ index did grow throughout the year but not as much as Google's stock price. It was consistently above the NASDAQ index almost the entire year.

As can be seen by examining the stock price chart, immediately after the press release was made available, the stock price rose sharply. The market considered the press release “good news,” but after January the stock price does not perform exceptionally well. It seems to fall back down, but not to where it was before the press release. Wall Street analysts seem to be very concerned with how companies do compared to the analysts own predictions, but it could be that their predictions were just wrong. However, this rise in stock price is fairly inconsequential if you examine Google’s stock price over the lifetime of the firm.

### **Wall Street Journal Article Discussion**

The *Wall Street Journal* seems to have mixed reviews about the earnings release. Google’s revenue was more than predicted, due to their growth in advertising revenue. It would be interesting to see what other advertisement based companies’ revenues were that quarter, to see if it was specific to Google or industry wide. The analysts’ reaction seem somewhat neutral, as does the entire article. With a company as large and influential as Google, a large decrease in stock price is fairly rare. The article is somewhat consistent the performance of the stock price, but not as positive as one would think when looking at the stock charts.

The seventeen percent increase in advertising revenue was a major factor in the market’s positive reaction. However, Google’s cost per click has increased eighty percent, which could be a cause for concern. Google’s capital expenditures of approximately 7.4 billion dollars in 2013 was used mostly to upgrade the company’s data center, to increase performance across all of their platforms. The sale of Motorola and rise in application sales on the Google Play store also contributed to the positive market performance. The increase in smartphone and mobile device

use should be on investor's and analyst's radars in the near future. As with any company this large, the countless moving parts make analyzing performance extremely difficult.