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ACCOUNTING ISSUES: AN EXAMINATION OF PROFESSIONAL AND ACADEMIC ACCOUNTING TOPICS THROUGH CASE STUDIES

By

Reynolds Spencer

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

April 2020

Approved by

Advisor: Dr. Victoria Dickinson

Reader: Dr. W. Mark Wilder

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I have so many people to thank for my education from The University of Mississippi. First, I must thank my parents for their constant support throughout my educational career. I have my parents to thank for instilling a work ethic in me that has driven me through the rigorous Patterson School of Accountancy curriculum. Second, thank you to the teachers, administrators, alumni, and peers who have made the Patterson School of Accountancy into such a challenging and high-quality education. Thank you to the faculty, staff, and fellow students of the Sally McDonnell Barksdale Honors College that made my experience and education so wonderful. Thank you finally to Dr. Victoria Dickinson for your guidance and direction as I completed this thesis – your passion for students does not go unnoticed.

ABSTRACT

JOHN REYNOLDS SPENCER: Accounting Issues: An Examination of Professional and Academic Accounting Topics through Case Studies
(Under the Direction of Dr. Victoria Dickinson)

The following thesis investigates prevalent topics to the accounting profession and academia. The thesis is comprised of twelve case studies performed over the course of eight months related to problems facing the accounting profession, things to consider when entering the profession, and analysis of existing and fictitious companies. The backgrounds for case studies two, six, seven, eight, nine, ten, and twelve were provided by Cases in Financial Reporting by Michael Drake, Ellen Engel, Eric Hurst, and Mary Lea McAnally, as presented in the works cited page. Case study four's background was provided by Dr. Brett W Cantrell. All other case study backgrounds were provided by Dr. Victoria Dickinson. Analysis provided in this thesis is the original analysis of the cited case studies. Each case study focuses on a different accounting topic and each case study contains an individual conclusion related to the case study's topic. The aggregate of the twelve case studies demonstrates a firm understanding of concepts learned in undergraduate accounting coursework, as well as a firm understanding of the topics facing the accounting profession.

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Case One

Data Analytics Case

5 September 2018

Introduction

As technology and computing have exponentially increased over the past couple of decades, opportunities have increasingly arisen for businesses to collect, process, and utilize data to make informed decisions. Improvements in technology allow software to collect data from more sources, more quickly, store more data, and analyze data better than software has ever been able to in the past. Therefore, data analytics tools have become increasingly useful for companies to use to gain advantages over their competitors by making timelier and better-guided decisions. This case will explore the potential of a data software named Domo to benefit a public accounting firm in its audit and tax planning practices.

By exploring specific scenarios for which Domo is useful to specific accounting practices, my understanding for Domo's software as well as the catch-all term – "data analytics" – became more concrete in nature. This case provided me with the opportunity to also explore inefficiencies in accounting practices and how a data analytics software could smooth-over such inefficiencies. As businesses are turning more and more to data analytics, this case serves as a useful investigation into the capability of the data analytics software, Domo, to improve accounting practices in public accounting firms. A career in public accounting will require finding innovative solutions to complex problems. The analysis of a software such as Domo as performed in this case study serves as a meaningful practice in arriving at innovative solutions to problems that accounting firms face using tools available on the market.

A. History and purpose of Domo

CEO Josh James founded Domo in 2010 as a technology startup company based out of Utah. According to Crunchbase, Domo received its first $10 million in funding during its seed stage in 2011 in the form of angel investors and has raised almost $700 million to date (Domo). Domo is a platform that can bring in data from over 500 data sources and aggregate all the data so that the data can be viewed dynamically in one place. CEO James said in an interview with Business Insider that Domo's dashboard separates itself from similar products since "There's no other [dashboard] in the world that has every bit of data about just one company" (Weinberger). Domo therefore makes data more available and more visible to those to whom the data is relevant, which allows everyone in the company to be on the same page in real-time.

B. How Domo is used to make business decisions:

By incorporating all data relevant to companies in real-time, companies can use Domo to make decisions founded on both timely and holistic information. Domo provides extensive analytical capabilities through the over 300 different types of interactive charts and dashboards available on the platform ("Product Overview | Domo"). Domo also does an excellent job of dispersing information throughout the company which enables collaboration among those involved in decision-making. Domo even has a mobile app which permits remote access to the data, so that decision makers can access the data on the go. This way, the company's decision makers can get the information that they need at any time.

C. Domo's Use in Audit and Tax Settings

i. Auditing

Syncing client's data: Auditing requires the validation of immense amounts of data. Domo has the capability of extracting and combining data from any third-party source. By using Domo's platform, an auditor can quickly sync a client's inventory data, sales data, or income data with Domo. Domo can more efficiently clean, organize, and store data than can an auditor, freeing up the auditor's time to perform higher-level, more meaningful audit work.

More effectively evaluate internal controls and catch irregularities: Domo's extensive information and large number of data connecters provide, according to its website, "ultimate visibility" into a company ("IT Self-Service and Governance Tools"). The visibility Domo adds by gathering data from all relevant sources of a company allows auditors to more easily detect misstatements in a client's financial reporting. This transparency also allows auditors to more effectively evaluate a company's system of internal controls through the added visibility into the client's processes.

Timely insights into deviations from a business's normal behavior: Not all irregularities in companies' statements are due to misreporting. Take a retail business such as Target for example, which states in its 10-K that, "A larger share of annual revenues and earnings traditionally occurs in the fourth quarter because it includes the November and December holiday sales period" (Target, Inc.). Auditors can use Domo's real-time industry data to compare Target with competitors to uncover industry-specific seasonality trends. The real-time

industry data will allow auditors to more effectively differentiate between misreporting and genuine changes in operating levels in time for the client to file their necessary reports with the SEC.

ii. Tax Planning

Better predict tax liabilities: Included in the wide breadth of data that Domo can extrapolate is external data such as social media and related industry/market data. With such insight, Domo can better predict demand for a company which will aid in predicting revenues, income, and ultimately tax liability. If the public accounting firm's tax accountants can pull more information on its client with Domo, they can make more accurate predictions about prospective tax liabilities.

Better Evaluate Current Tax Liabilities: In addition to offering prospective insight into tax liabilities, Domo's platform allows a company to retrospectively evaluate its tax liabilities. For instance, say that a client has discovered a sudden increase in its tax expenses. Tax accountants can use Domo to pull income information from internal sources across multiple divisions and pinpoint areas in which the company's tax liabilities are higher than others by using Domo's extensive analytical tools. After pinpointing what is driving increased tax liabilities, the accountants can experiment with ways to decrease tax liability in a way that makes the company more profitable.

Determine Ramifications of Growth: For a company to survive, it must grow. Growth can come in the forms of mergers and acquisitions or expansion into new regions. For any sort of growth, there will be tax ramifications. If a client is

looking to expand, they will need a tax accountant to analyze prospective taxation ramifications. Such critical analysis requires an extensive look into internal data of the company as well as external data relating to other companies and tax data from different regions. Domo would enhance a firm's services by allowing the firm to efficiently pull relevant internal and external data and look at it on a single platform. Visualizing internal and external data on one platform will allow more efficient analysis of tax ramifications than would looking at such data separate.

D. Example Memo Recommending Use of Domo Software to Accounting Firm

To: John Doe, Partner
From: Reynolds Spencer, Staff
Subject: Domo Software Recommendation
Date: 9/5/2018

This memo serves to provide information about Domo data analytic software and ultimately recommend the acquisition of the Domo software for the firm's audit and tax practices. Domo will enhance the firm's services to clients through increased efficiency as well as better analysis. Enhanced efficiency and analysis will provide both price and product differentiation and open the door to an increase in the client base.

Domo increases efficiency by extracting, storing, and displaying extensive amounts of information in one place. Domo Application Program Interfaces (APIs) allows companies to program the management of data so that less time is spent on finding, downloading, and storing data and more time is spent on analysis of data ("Domo APIs"). Increased efficiency results in less time as well as lower costs to clients. While lower costs do equal less revenue to the firm in the short-term, they increase client

satisfaction and increase retention among current clients while attracting new clients, increasing revenue in the long-term.

Domo's analytical capabilities are flexible and can be used for any client. Domo has its own, ever-expanding Appstore with a multitude of data analytics applications. In addition to existing applications, Domo has its own design studio which allows the construction of custom applications. With so many tools available to it, the firm will be able to meet every analytical need of even the most diverse client base. Domo leaves it up to the firm to organize the platform how it sees best. This flexibility allows the firm to differentiate its services from competitors.

For the platform's full, collaborative potential to be realized, it will need to adequately train all employees in Domo. Domo allows collaboration through the flow of information, but this collaboration is possible only if everyone in the firm is literate in the software. PC Magazine noted in an article that Domo is worthwhile "for those willing to invest in the steep learning curve required" (Baker). Since the platform is not intuitive, Domo will require extensive training, but once integrated into the fabric of the company, the firm will have an extreme advantage over competitors who are less willing to invest in the product in fear of the steep learning curve.

Acquisition of Domo and related training will require a technologically literate staff. The training in and maintenance of Domo will require a strong IT department who can educate all staff-members on the platform, customize the Domo platform to the management's specifications, and solve any problems that may arise with the platform. Domo's application customization capability also offers the competitive opportunity for the firm to employ personnel who are capable programmers. The use of Domo will

strengthen the firm's analytical capabilities, therefore allowing it to grow its advisory practice, and the platform's flexibility will allow the company to handle a larger and more diverse client base.

Conclusion

An effective data analytics software can enhance client service delivery and efficiency for a public accounting firm. Domo accomplishes these tasks by aggregating all the information from the client in one place. By investigating how an accounting firm could use Domo's software across its different service lines, I was able to investigate how data analytics could improve the public accounting profession. Additionally, this case study was a practice in aggregating and communicating information to higher-ups in the form of a proposal memo (Part D).

Case Two

The Accounting Cycle

12 September 2018

Introduction

This case demonstrates a condensed run through the accounting cycle for the Rocky Mountain Chocolate Factory, Incorporated. I would expect Rocky Mountain Chocolate Factory, a chocolate producer and retailer, to have large balance sheet accounts such as inventory; accounts receivable from sales; property, plant, and equipment for the production of chocolate; accounts payable for suppliers; and common stock since it is incorporated and has publicly traded ownership interests. I would also expect the Income Statement to consist primarily of sales revenues and cost of goods sold, as well as depreciation on the factories. This case demonstrates the financial statement preparation process from the origination of journal entries, adjustment and closing entries, and the ultimate preparation of financial statements. This case also provided technical training in Excel, such as learning how to effectively link data from the general journal, to the income statement, and ultimately the balance sheet. A career in public and private accounting requires extensive understanding of the process of preparing financial statements.

A. Rocky Mountain Chocolate Factory, Inc. Journal (Figure 2-1)

The next page contains Rocky Mountain Chocolate Factory, Inc.'s journal entries for February 2009. Activity that the journal entries in Figure 2-1 are based on was provided by the case background (Drake, Engel, Hirst, McAnally).

	Figure 2-1: Rocky Mountain Chocolate Factory, Inc. Journal	Beginning Balance (February 28, 2009)	1. Purchase Inventory	2. Incur Factory Wages	3. Sell Inventory for Cash and on Account	4. Pay for Inventory	5. Collect Receivables	6. Incur SG&A (Cash and Payable)	7. Pay Wages	8. Receive Franchise Fee	9. Purchase PPE	10. Dividents Declared and Paid	11. All Other Transactions	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 (ending) Balance	Actual February 28, 2010 F/S Figures
Dr	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	$ 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	4,427,526
	Notes Receivable, Current	0											91,059	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	3,281,447
	Deferred Income Taxes	369,197											92,052	461,249					461,249		461,249	461,249
	Other	224,378											(4,215)	220,163					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	5,186,709
	Notes Receivable, Less Current Port	124,452											139,198	263,650					263,650		263,650	263,650
	Goodwill, Net	1,046,944												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	110,025
	Other	91,057											(3,007)	88,050					88,050		88,050	88,050
Cr.	Accounts Payable	1,074,643	7,500,000			(8,200,000)							503,189	877,832					877,832		877,832	877,832
	Accrued Salaries and Wages	423,789		6,000,000					(6,423,789)					0			646,156		646,156		646,156	646,156
	Other Accrued Expenses	531,941						3,300,000					(2,885,413)	946,528					946,528		946,528	946,528
	Dividend Payable	598,986										3,709	(1)	602,694					602,694		602,694	602,694
	Deferred Income	142,000								125,000			(46,062)	220,938					220,938		220,938	220,938
	Deferred Income Taxes	827,700											66,729	894,429					894,429		894,429	894,429
	Common Stock	179,696											1,112	180,808					180,808		180,808	180,808
	Additional Paid-In Capital	7,311,280											315,322	7,626,602					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	3,343,850
	Sales	0			22,000,000								944,017	22,944,017					22,944,017	(22,944,017)	0	22,944,017
	Franchise and Royalty Fees	0											5,492,531	5,492,531					5,492,531	(5,492,531)	0	5,492,531
Dr.	Cost of Sales	0			14,000,000								693,786	14,693,786	216,836				14,910,622	(14,910,622)	0	14,910,622
	Franchise Costs	0											1,499,477	1,499,477					1,499,477	(1,499,477)	0	1,499,477
	Sales & Marketing	0						1,505,431						1,505,431					1,505,431	(1,505,431)	0	1,505,431
	General and Administrative	0						2,044,569					(261,622)	1,782,947			639,200		2,422,147	(2,422,147)	0	2,422,147
	Retail Operating	0						1,750,000						1,750,000			6,956		1,756,956	(1,756,956)	0	1,756,956
	Depreciation and Amortization	0												0		698,580			698,580	(698,580)	0	698,580
	Interest Income	0											(27,210)	(27,210)					(27,210)	27,210	0	(27,210)
	Income Tax Expense	0											2,090,468	2,090,468					2,090,468	(2,090,468)	0	2,090,468
	A = L + OE + R/E																					

B. Income Statement (Figure 2-2)

The figure below (Figure 2-2) contains Rocky Mountain Chocolate Factory, Inc.'s Income Statement for the year ended February 28, 2010. The Income Statement was derived from the transactions presented in Figure 2-1.

Figure 2-2: Rocky Mountain Chocolate Factory, Inc.
Income Statement
For the Year Ended February 28, 2010

Revenues		
Sales	$	22,944,017
Franchise and Royalty Fees		5,492,531
Total revenues		28,436,548
Costs and Expenses		
Cost of Sales		14,910,622.00
Franchise Costs		1,499,477
Sales & Marketing		1,505,431
General and Administrative		2,422,147
Retail Operating		1,756,956
Depreciation and Amortization		698,580
Total costs and expenses		22,793,213
Operating Income		5,643,335.00
Other Income (Expenses)		
Interest expense		
Interest Income		27,210
Other, net		27,210
Income Before Income Taxes		5,670,545
Income Tax Expense		2,090,468
Net Income	$	3,580,077
Basic Earnings per Common Share		$0.60
Diluted Earnings per Common Share		$0.58
Weighted Average Common Shares Outstandi		6,012,717
Dilutive Effect of Employee Stock Options		197,521
Weighted Average Common Shares		6,210,238

C. Balance Sheet (Figure 2-3)

Figure 2-3 (below) contains Rocky Mountain Chocolate Factory, Inc.'s Balance Sheet as of February 28, 2010. The Income Statement (Figure 2-2) presents the activity that occurred throughout the period. The Balance Sheet (Figure 2-3) displays a snapshot of the company's financial position after the period's activity.

Figure 2-3: Rocky Mountain Chocolate Factory, Inc.
Balance Sheet
For the Year Ended February 28, 2010

Assets		
Current Assets		
Cash and Cash Equivalents	$	3,743,092
Accounts Receivable		4,427,526
Notes Receivable, Current		91,059
Inventories		3,281,447
Deferred Income Taxes		461,249
Other		220,163
Total Current Assets		12,224,536
Property and Equipment, Net		5,186,709
Other Assets		
Notes Receivable, Less Current Portion		263,650
Goodwill, Net		1,046,944
Intangible Assets, Net		110,025
Other		88,050
Total Other Assets		1,508,669
Total Assets	$	18,919,914
Liabilities and Stockholders' Equity		
Current Liabilities		
Accounts Payable	$	877,832
Accrued Salaries and Wages		646,156
Other Accrued Expenses		946,528
Dividend Payable		602,694
Deferred Income		220,938
Total Current Liabilities		3,294,148
Deferred Income Taxes		894,429
Stockholders' Equity		
Common Stock	$	180,808
Additional Paid-In Capital		7,626,602
Retained Earnings		6,923,927
Total Stockholders' Equity		14,731,337
Total Liabilities and Stockholders' Equity	$	18,919,914

D. Impact of Fiscal Year 2010 Activity on Statement of Cash Flows

Transactions that affect current assets or current liabilities and general revenues and expenses impact the operating section of the Statement of Cash Flows. Of the non-adjusting/closing transactions in the journal (Figure 2-1, entries one through ten), transactions one through eight all fall into the operating category, because transactions such as purchasing and paying for inventory, incurring and paying factory wages, selling inventory and collecting receivables, and receiving a franchise fee result from Rocky Mountain's current period operations. The purchase of property, plant, and equipment (PPE) in transaction nine (Figure 2-1) impacts the investing section of the Statement of Cash Flows, because Rocky Mountain will recognize value from its investment in the PPE in future periods. The declaration and payment of dividends impact the financing activities section of the Statement of Cash Flows, because such activity relates to the raising of funds to support Rocky Mountain's performance of operating and investing activities through the issuance of stock.

Conclusion

As expected, accounts receivable and inventories account for nearly three quarters of Rocky Mountain's current assets. Property, plant, and equipment is also a substantial asset account. Accounts payable accounted for a smaller portion of Rocky Mountain's current liabilities than I had expected, which may be due to Rocky Mountain being extremely liquid and able to meet current obligation, as its current assets are four times larger than its current liabilities. As expected, Rocky Mountain's sales and cost of Goods Sold account for a substantial portion of its revenues and expenses relatively.

Case Three

Career Scenarios Case

18 September 2018

Introduction

This case examines relevant dilemmas faced by soon-to-be accounting professionals. These dilemmas have been created through conflicting interests of The Patterson Accounting School, public accounting firms, and accounting students. Public accounting firms invest a significant amount in new hires and have often suffered substantial losses from new hires who do not stay with the firm long enough for the firm to recoup its investment (it is believed that firms recoup their investment on new hires in three to five years). This dilemma facing public accounting firms is rather unique, since the firms depend so heavily on their human-capital. The future of the accounting profession will be determined by career decisions made by those who are entering the field in the coming years. Reasoning through the following three scenarios elicited contemplation of professional decisions as well as an enhanced understanding of the issues interests and conflicts facing the accounting profession.

A. *Scenario #1:* **One student is weighing going to law school upon completion of their Patterson School of Accountancy program to study tax law over obtaining a master's degree in tax accounting at The University of Mississippi. The student also would like to go through with their Accounting internship.**

Many overlaps exist between tax accounting and tax law in practice. The advantages to entering tax law are heightened expertise in the tax field, increased employment demand, and greater salary. The disadvantages are the extreme costs of law school as well as the idea that interning at an accounting firm without plans

to work at one after college would be a waste of time and resources for the student as well as the firm. With all factors considered, the best route for the student appears to be to enter the Public Accounting field and go back to law school after years of experience and savings. This path capitalizes on the advantages of obtaining a law degree while minimizing the noted disadvantages.

Accounting graduates tend to not enter the public accounting field with all the knowledge necessary to perform their jobs. This fact is not due to shortcomings of higher education but rather due to knowledge that graduates can only obtain through experience in tax accounting. Firms know this fact, which is why firms invest in developing and educating recent graduates. By completing the accounting internship and then gaining two to three years of experience in tax accounting at a public accounting firm, the student will hold far more knowledge in the tax practice than the student did upon graduation from The Patterson School. Working at a public accounting firm prior to attending law school would greatly prepare the student for the rigorous law school curriculum. Upon the completion of law school, the student will be highly sought after due to the experience in tax accounting coupled with the law degree.

The major drawbacks of this student opting into law school would be the extreme cost of law school as well as the potential waste of time and resources by the employer and the student. This potential waste would be material should the student decide to go through with their internship and then immediately attend law school upon graduating as opposed to accepting a full-time position with the firm at which they interned. However, should the student follow the suggested

path of working for the firm for two to three years before entering law school, the student would have the opportunity contribute to the firm in a material way and offer a return on the firm's investment in recruiting while simultaneously gaining valuable and relevant experience. Additionally, the student would offset part of the cost of law school by earning and saving for three years at the firm. The student could also manage left-over debt from law school with the increased pay which they would likely earn once re-entering the workforce with a tax law degree.

B. *Scenario #2*: **A student is looking to enter investment banking via an accounting degree from The University of Mississippi.**

Accounting is known as the "language of business." Because of this, accounting expertise enables recent-graduates to work in a variety of business fields – investment banking included. The student in this scenario finds passion in investment banking but feels that a degree in accounting holds more merit, so the student would like to go through with an accounting major and internship. Due to the portable nature of the accounting degree, the student would benefit greatly from accounting knowledge, and due to the prestige of an Bachelor degree in Accounting from The University of Mississippi, the student would become a sought-after job candidate upon completion of the accounting program. However, when the time comes for the student to intern as a part of their curriculum, the student would benefit more from seeking out an investment banking internship than an accounting internship due to the student's passion for investment banking

coupled with increased job prospects that would arise from internship experience in the relevant field.

While accounting provides a very sturdy foundation for investment banking, the student will need to learn on the job as an investment banker. For this reason, doing an internship would benefit the student through the extensive knowledge and training that the student would gain as an intern. Additionally, job prospects within the investment banking field would become far greater if the student were to have experience and references that could speak to the student's capabilities in investment banking.

This scenario differs from the previous scenario in that this student's lies in a field other than accounting. The overlap between tax law and tax accounting are greater than the overlap between accounting and banking. A desired focus on the legal aspects of tax accounting drives the shift in career path in the first scenario, while a lack of passion in accounting drives the shift in the education and career paths in this scenario. The student in this scenario would waste time and resources by pursuing internships and careers in accounting due to the student's lack of passion and interest. While it would have been rational for the student in the first scenario to spend time in tax accounting only to progress into tax law, the same logic does not apply for the student in this scenario. The student in this scenario should follow his passion for investment banking. While this student would benefit from obtaining knowledge in the "language of business" by way of an accounting major, it would not benefit the student to spend time in an internship or career field that do not optimize the student's interests.

C. *Scenario #3*: A student is considering a transfer from a Big Four firm in Washington D.C. to an office in Dallas, Texas upon the completion of their master's degree at The University of Mississippi.

One of the greatest decisions that must be made as a student prepares to launch a career is where to land post-graduation. Finding enjoyment in the location in which the student work impacts student's effectiveness as an employee. An equally (if not more) important consideration is the student's personal well-being outside of work. This is a difficult decision for a 20- to 21-year-old to make – a decision which some may not get right. This student completed the internship, and as they near the completion of the Accounting graduate program, the student is exploring the possibility of transferring the firm's job offer to the firm's Dallas office. A position in Dallas's office is highly competitive, so there is little guarantee that the student would land a position at the firm. For this scenario, it is important to consider both the well-being of the student and the interests of the accounting firm's D.C. office, which has poured resources into drawing the student to their office.

Accounting firms invest $175 thousand, on average, in the recruitment and training of accounting students. Due to this, it would be highly advised that the student transfer only if the same firm's Dallas office could take the student. If a major life event draws the student to Dallas, then the scenario changes and more measures would reasonably need to be taken to move to Dallas. However, if it is a matter of disliking the city after a ten-week internship, then it may be worth the

student staying with the D.C. office for two to three years to get a better sense of the city, which is also the amount of it takes for the firms to recognize a reasonable return on their investment in the student. The well-being of the employee matters, so if the student still does not enjoy the location of the firm or the office itself after a reasonable amount of time, then opportunities will exist for the student to eventually move back to Dallas. The decision to transfer nearly a year after the completion of the internship appears irrational and unfair to the firm, barring any major life-events. Above all else, throughout the entirety of this process, the student need be transparent with the firm.

Conclusion

While the specific scenarios and recommendations vary, the overarching theme of each suggestion is that the students balance self-optimization (personally and professionally) with the interests of the firms involved in recruitment and employment of the students. To the extent to which the student can without infringing on personal and professional advancement, the students ought not to waste the time and resources of the firms which employ the students as interns or full-time CPAs. While I currently relate best to the students in the three scenarios, upon entering the profession in 2021, I will experience the other side of the coin and need to look out for the interests of the accounting profession. As I placed myself in the shoes of public accounting firms, I obtained a greater understanding of the problems which the industry I will soon enter faces.

Case Four

Accounting for Debt Securities Sales and Impairments

3 October 2018

Introduction

Determination of debt security impairment requires extensive examination of various factors. This case investigates the factors which determine debt security impairment through careful analysis of the fictional Generic Bank's security portfolio, financial statements, and the short and long-term strategy of the bank. Impairment determinations are extremely necessary as they materially impact the timing and amounts of earnings reported by the bank. Completion of this case study allows for a better understanding of accounting rules and procedures as they pertain to impairment of debt securities. This case also provided an effective practice in consulting authoritative literature to arrive at a conclusion. Applications in the accounting profession of knowledge obtained from this case can be seen in audit and advisory services provided to banks. For a public accountant to perform an audit of a bank, the CPA must understand rules and regulations regarding impairment. Advisory professionals will need to factor in causes and implications of security impairment to advise on banking strategy.

A. Impairment Loss on Securities in Figure 4-1 if Sold in Early 20x3

For this case, all Generic Bank's securities are assumed to be available for sale (AFS) securities. Assume that Generic Bank's CFO intends to sell the securities listed in Figure 4-1 in early 20x3. According to FAS statement 115, unrealized gains and losses on AFS securities are excluded from earnings ("Accounting for Certain Investments in Debt and Equity Securities"). Under this assumption alone, Generic Bank would realize losses on the seven securities in Figure 4-1 only when the bank sells the securities in 20x3. However, according to

ASC 326-30, Generic bank must make the determination of whether the securities in unrealized loss positions are impaired, since unrealized loss on impaired securities would reduce income. Therefore, Generic Bank determines that the securities are impaired, then the bank must recognize an impairment loss in 20x2 (as opposed to when they are sold in 20x3). Therefore, the outcome of the impairment analysis of the Figure 4-1 securities will determine the timing of loss recognition.

For Generic Bank to avoid realizing an impairment loss, it must assert that it has the "intent and ability to hold these unrealized loss debt securities until they can recover their amortized cost basis" (Cantrell 3). The sale of the seven securities would result in a material loss of $54.209 million – the net deficit of the fair values of the seven securities to their amortized costs (Figure 4-1). However, only five of the seven securities are in unrealized loss positions. Securities 067 and 096 are in unrealized gain positions, which would not be recognized as impairment losses during 20x2 but rather realized as gains upon sale in 20x3 (assuming little to no change to the fair values of the securities by the time that Generic Bank sells them). The 20x2 impairment loss would be recorded only for the securities in unrealized loss positions.

Due to the material loss positions of securities 003, 015, 025, 030, 076 and the lack of intent to hold the securities, Generic Bank cannot reasonably assert that the five securities in loss positions are not impaired. Therefore, Generic Bank should recognize an impairment loss of $78,414 million in 20x2 for the securities (Figure 4-1) in loss positions.

Figure 4-1: Generic Bank Available for Sale (AFS) Security Detail (Numbers in Thousands)

Security Type	CUSIP	Description	Amortized Cost	Fair Value
State and Political Subdivisions	0XXXXX003	Municipal Bond – City of Los Angeles	57,652	42,968
Mortgage-Backed Securities	0XXXXX015	FHLMC Residential Single-Family MBS - 3	77,759	77,586
Mortgage-Backed Securities	0XXXXX025	FHLMC Residential Single-Family MBS - 13	52,188	29,650
Mortgage-Backed Securities	0XXXXX030	FNMA Residential Single-Family MBS - 3	66,785	54,457
Mortgage-Backed Securities	0XXXXX067	FNMA Residential Multi-Family MBS - 5	39,545	55,883
Mortgage-Backed Securities	0XXXXX076	Private Label Residential Multi-Family MBS – 4	42,115	13,424
Other Securities	0XXXXX096	Corporate Bonds – JKL Corporation	50,000	57,867
		Total	386,044	331,835

**The above detail was borrowed from the case study to provide a reference for the analysis performed throughout the case (Cantrell 10).*

B. Impairment Loss on Securities Other than those Presented in Figure 4-1

The following analysis operates under the assumption that Generic Bank still sells the securities in Figure 4-1 shortly after year-end 20x2. Upon analysis of Generic Bank's remaining securities not mentioned in figure 4-1, mortgage-backed securities (MBS) account for the most substantial net unrealized losses, totaling $437 million and around 60 percent of Generic's unrealized losses are attributed to securities which have been in unrealized loss positions for over a year (Figure 4-4). Whether the bank can recover the fair value of the securities and therefore need-not recognize impairment on securities rests in the intent and ability of Generic Bank to hold the MBS until they recover their amortized costs. Generic Bank does intend to hold onto the mortgage-backed securities, but whether it has the ability to hold the securities is partly determined by the adequacy of the bank's existing capital (assuming that none of the impairments

are due to credit-losses). The Federal Depository Insurance Commission (FDIC) requires that banks maintain minimum values for two types of capital ratios: risk-weighted capital ratios and leverage ratios.

i. Generic Bank's Leverage Ratio

According to FDIC Rules and Regulations § 325.3b.2, depositories such as Generic Bank must maintain a minimum ratio of tier 1 capital to total assets of four percent – furthermore, "tier 1 capital is the most loss-absorbing form of capital. It includes qualifying common stock and related surplus net of treasury stock; retained earnings; certain accumulated other comprehensive income (AOCI)" ("Rules, Regulations, Related Acts"). Upon analysis of Generic Bank's balance sheet information (Figure 4-3), the bank exceeds the four percent minimum leverage ratio requirement by maintaining a ratio of 5.39 percent. The leverage ratio for Generic Bank as of year-end 20x2 is calculated below, where all Generic Bank's stockholder's equity was deemed tier 1 capital:

$$\frac{tier\ 1\ capital}{total\ assets} = \frac{554{,}739}{10{,}287{,}212} = 5.39\ \%$$

According to FDIC Rules and Regulations, a tier 1 leverage ratio of five percent or higher places Generic Bank in the highest capital category, which is – "well capitalized" ("Risk Management Manual of Examination Policies" 2.1-8). The leverage ratio backs Generic Bank's claim that it can hold onto the securities. Because Generic Bank's assets are backed by adequate capital, it can absorb more losses and better-meet financial obligations. A lower value of the leverage ratio would indicate that the company was backed less-favorably by liabilities, which

would render the company less able to absorb losses and less capable of meeting financial obligations. A low leverage ratio would raise concerns about the bank's solvency. Since the bank is in position to meet its financial obligations, it can hold onto the securities until they recover their amortized costs.

ii. Generic Bank's Risk-Based Capital Ratio

According to Appendix A to FDIC Rules and Regulation § 325, "A bank's risk-based capital ratio is calculated by dividing its qualifying total capital base by its risk-weighted assets," and the ratio should exceed eight percent ("Rules, Regulations, Related Acts"). This ratio serves a similar purpose as the leverage ratio in analyzing a bank's solvency, but the FDIC implemented the risk-based capital ratio requirement to better assess banks' abilities to absorb losses with their "risk profiles" considered. For example, the denominator in Risk-Based Capital Ratio (risk-weighted assets) is a total of Generic Bank's investment assets (Figure 4-3), weighted by risk factors as stated by the FDIC. Using the guidelines to risk-weighted factors ("Risk Management Manual of Examination Policies" 2.1-5), the US Treasury and US Agency bonds were given zero percent weights (little-to-no risk); State/Political securities were given 20 percent weights (little risk); since all of the bank's loans held for sale are in real estate, consumer, or commercial loans, they were given 100 percent weights. The guidelines state that the bulk of the assets typically found in a loan portfolio are given 100 percent weights, so when insufficient information was provided in the case for the investment grade of MBS and "Other" securities, the securities were assigned 100 percent weights as defaults.

Figure 4-2: Calculation of Generic Bank's Risk-Weighted Capital Ratio (numbers in thousands)

Security Type	Total Security Type Fair Value*	Security Risk-Weight (%)**	Security Risk-Weight ($)
State and Political Subdivisions (AFS)	286,907	20%	57,381.4
U.S. Treasury and Govt. Agency (AFS)	81,239	0%	0
Mortgage-backed Securities (AFS)	3,535,436	100%	3,535,436
Other AFS Securities	131,110	100%	131,110
Loans Receivable (Figure 4-3)	10,610	100%	10,610
		Risk-Weighted Assets	3,734,537.4

**Figure 4-4*
***Provided in FDIC Risk Management Manual of Examination Policies (page 2.1-5)*

$$\frac{Total\ Capital\ Base\ (a)}{Risk\text{−}Weighted\ Assets} = \frac{554{,}739}{3{,}734{,}537.4} = 14.85\%$$

(a) Total Capital Base = Total Stockholders' Equity (Figure 4-3)

Generic Bank's risk-based capital ratio of 14.85 percent (Figure 4-2) well exceeds the FDIC minimum requirement of eight percent. Banks with a total risk-weighted assets ratio of 10 percent or higher are categorized as "well capitalized" according to section 2.1 of FDIC's Risk Management Manual of Examination Policies ("Risk Management Manual of Examination Policies" 2.1-8). Generic Bank's high-grade risk-weighted assets ratio indicates that it has enough capital to absorb losses by its risk-based assets.

Because Generic Bank meets the capital requirements set forth by the FDIC, it may reasonably assert that it has both the intent and ability to hold the remainder of its securities until they recover their amortized costs. Additionally, of the 55 investments in net loss position, none are impaired due to credit loss. Therefore, Generic Bank does not have any additional impaired securities.

Figure 4-3: Generic Bank's Consolidated Balance Sheet for the year-ended 20x2 (numbers in thousands)

	20x2		20x1	
Assets:				
Cash and amounts due from depository institutions	172,490		143,489	
Interest–bearing deposits in other financial institutions	112,501		99,996	
Cash and cash equivalents		284,991		243,484
Loans held for sale		10,610		14,397
Securities available for sale		4,034,692		4,389,935
Loans receivable	5,738,395		5,308,669	
Unamortized loan origination fees, net	(10,611)		(10,864)	
Allowance for loan losses	(91,814)		(90,247)	
Loans receivable, net		5,635,970		5,207,558
Real estate owned		5,371		13,075
Accrued interest and dividends receivable		41,760		37,611
Premises and equipment, net		178,686		163,020
Goodwill and other intangibles, net of amortization		65,338		67,283
Other assets		29,794		25,655
Total assets		$ 10,287,212		$ 10,162,018
Liabilities and Stockholders' Equity				
Liabilities:				
Deposits	4,341,902		3,735,908	
Borrowings	3,950,420		4,461,861	
Advance payments by borrowers for taxes and ins.	17,785		15,341	
Deferred income taxes	1,297,527		1,088,471	
Other liabilities	124,839		120,081	
Total liabilities		9,732,473		9,421,661
Stockholders' equity:				
Common stock	2,314		2,314	
Additional paid–in capital	475,498		447,948	
Treasury stock, at cost	(43,443)		(73,069)	
Unearned compensation – ESOP	(24,763)		(26,689)	
Retained earnings	573,476		452,684	
Accumulated other comprehensive income: Net unrealized holding gains (losses) on securities available for sale	(428,343)		(62,833)	
Total stockholders' equity		554,739		740,356
Total liabilities and stockholders' equity		$ 10,287,212		$ 10,162,018

**The above balance sheet was provided in the case study and included in the thesis in order to provide a reference for the analysis performed in Part B of case study 4 (Cantrell 7).*

C. Determination of Impairment Loss from Audit and Regulatory Perspective

i. Assuming the role of Heather Herring, the external auditor

The role of the external auditor is to verify the accuracy of Generic Bank's accounting controls and reporting in accordance with FASB and SEC guidance

and regulation. An external auditor would be more skeptical as to the bank's ability to hold onto the securities than would Generic Bank's CFO. From a 50 thousand-foot view, the bank's capital ratios meet regulatory requirements, but the auditor must now validate the numbers behind the ratios. If credit loss did exist on the securities, then they would in-fact be impaired. However, without information present pertaining to credit-loss in this case, the assertion that remaining securities are not impaired does not change under the assumption of the role of an external auditor.

ii. Assuming the role of a bank regulator

The role of the bank regulator is to ensure that Generic Bank is well-capitalized in accordance with FDIC regulation and other regulatory bodies. The bank regulator will want to ensure that the bank is classifying its securities and loans in accordance with FDIC regulations. The regulator would investigate how the company determines impairment of securities and verify that such determinations are in accordance with FDIC rules. The bank regulator would focus more on the bank's ability to hold onto the securities than its intent. If the bank has a reasonable intent to hold onto its debt securities, which its well-capitalized nature suggests it does, Generic Bank's assertion that its securities that it does not intend to sell (in other words, the rest of Genric's securities not mentioned in Figure 4-1) are not impaired still stands.

iii. Other Factors to Consider

The bank regulator, with more information regarding the individual securities than were provided in this case, will be able to determine whether the bank is applying the correct risk factors to the bank's assets when calculating the risk-weighted ratio. A bank regulator would need to obtain, for instance, the investment grades of mortgage-backed securities before determining whether the bank is well capitalized ("Rules, Regulations, Related Acts"). FASB has recently implemented a new credit-loss model that will be extensively used by external auditors in assessing the impairment of securities. According to a publication by PwC, financial statement preparers under the new model "will need to consider not only their method for estimating CECL [the new credit loss model], but also the evidence and documentation their governance and internal control framework should produce to support their estimates" (Hurden). With this new model in mind, the external auditor would need physical documentation and evidence regarding internal controls for impairment of securities as part of the auditing process – a statement of the financial institution's methods alone would not suffice.

D. Effect of Change in Securities' Collective and Individual Gain/Loss Positions on Impairment Assessment from Part A

i. Assuming Securities Sold had been Collectively in a Net Gain Position

If the securities Generic Bank intended to sell (securities in Figure 4-1) were collectively in a net gain position, then an impairment loss would still be recognized on any securities in individual loss positions. This is due to the bank's intent to sell the securities in loss positions. Although a reasonable assumption may exist that the securities could recover their amortized costs, the U.S. Securities and Exchange Commission reports in Staff Accountancy Bulletin No. 59 that a factor that suggests that impairment of a security has occurred is, "the intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any recovery in market value" ("Codification of Staff Accounting Bulletins"). Without the intent to hold the securities until the losses are recovered, the securities in net loss positions must be impaired as FASB staff has noted that impairment occurs in "situations where the security will be disposed of before it matures" ("Recognition and Presentation of Other-Than-Temporary Impairments").

ii. Assuming Each of the Securities Sold Were in Gain Positions

If each of the securities Generic Bank intended to sell in Part A (Figure 4-1) were in gain positions, then Generic Bank would not recognize impairment. The FDIC states that an impairment "occurs when the fair value of the security is less than its amortized cost basis" ("Accounting News: Other-Than-Temporary

Impairment of Investment Securities"). If the fair values of all the securities sold exceed the amortized costs of the securities, then no impairment exists. Although the bank intended to sell the securities, impairment occurs only when "it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement" ("Recognition and Presentation of Other-Than-Temporary Impairments"). Impairment does not exist under this assumption, because no reasonable or probable assertion exists that the bank would not collect all amounts due – the securities' expected cash flows (fair values) exceeds their amortized costs. Generic would recognize a gain upon the sale if the securities listed in Figure 4-1 were each in gain positions. If Generic Bank's debt securities which it did not intend to sell (i.e. Generic's remaining securities not in Figure 4-1) were in net gain positions, then the held securities would not be impaired either.

E. Impact of Downgrade in Capitalization Rating from "Well-Capitalized" to "Adequately Capitalized" on Impairment Loss Assessment

The FDIC categorizes "adequately capitalized" banks one grade below "well capitalized" banks. If Generic Bank is now assumed to be adequately capitalized, then it has enough capital to leverage its risk-based assets as well as its total assets, but it has the bare-minimum necessary to do so. The minimum leverage ratio to be considered adequately capitalized is four percent, and the minimum risk-weighted ratio is eight percent, as opposed to minimum five and ten percent respective leverage and risk-weighted ratio values necessary to be

considered well capitalized (“Risk Management Manual of Examination Policies” 2.1-8). A slight shift in capital structure or assets would render the bank undercapitalized.

Under the adequately capitalized assumption, Generic Bank’s ability to hold onto securities in net loss positions must be reassessed. According to bank’s financial records, $702 thousand in securities have been in net unrealized loss positions for over a year (Figure 4-4). Section 2.1 of FDIC’s Risk Management Manual of Examination policies requires that banks have a comprehensive strategy for maintaining appropriate levels of capital (“Risk Management Manual of Examination Policies” 2.1-8).

The bank’s ability to hold onto these securities is hindered by its lack of capital. While Generic Bank will still have the bare-minimum ability to hold onto its securities, its strategy and intent will need to be re-evaluated under the lesser, adequate capital structure. It may be necessary for the bank to liquidate its securities in order to meet obligations and remain solvent. The FDIC in the Section 2.1 notes that the FDIC may take formal enforcement actions even against banks with capital above the minimum amounts, so being adequately capitalized does not provide Generic Bank the freedom to irresponsibly hold securities (“Risk Management Manual of Examination Policies” 2.1-7). Aside from those that the bank sells, there are likely additional impaired securities which the bank would need to strategically sell due to its only adequate capital structure.

Conclusion

This case required a careful analysis of FASB, FDIC, and SEC regulation and guidance. Among other factors, the intent and the ability of Generic Bank to hold onto its securities were heavily investigated under varied assumptions. Analysis of Generic Bank's ability to hold onto securities was focused on the adequacy of its capital structure. Analysis of the bank's intent to hold onto securities was focused on the bank's short and long-term strategy. Analysis of causes and implications of impairments allowed for a greater understanding of accounting for securities. A broad summary of findings is as follows:

- under the assumption that the bank is well capitalized, impairment exists on securities in net loss positions which the bank intends to sell due to lack of intent by the bank to recover the amortized costs of the securities.
- Under the same capital structure assumption, securities other than the seven sold would not be impaired due to the bank's intent and ability to hold onto securities that arises from its favorable capital structure.
- Assuming the role of auditors and regulators, the conclusions made in requirements one and two would not change, but additional information would need to be gathered before affirming the bank's impairment claims.
- Securities in net gain positions would not be impaired according to FDIC rules and regulations, FAS No. 115., and SEC Staff Accountancy Bulletin No. 59.
- Banks with varied capital structures will have varied strategies for holding and selling securities. Banks with lesser capital structures will need to strategically sell more securities to free up assets, rendering more securities impaired.

Appendix A to Case 4

Figure 4-4: Supplemental Investment Securities Available for Sale Information

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
State/Political	258,246	54,454	(25,792)	286,907
U.S. Treasuries	57,525	0	(5)	57,520
U.S. Agency	25,064	0	(1,345)	23,719
MBS	3,972,606	681,596	(1,118,766)	3,535,436
Other	149,600	8,694	(27,184)	131,110
Total	$ 4,463,041	$ 744,743	($1,173,091)	$ 4,034,692
AFS Investment Securities in Continuous Unrealized Loss Position for <12 months	$ 1,148,982	$ 0	($ 471,282)	$ 677,700
AFS Investment Securities in Continuous Unrealized Loss Position for >12 months	$1,586,111	$ 0	($701,809)	$ 884,302

**The information in Figure 4-4 was provided by the case and included in the thesis for reference for analysis performed in this case study (Cantrell 9).*

Case Five

City Research Case

7 November 2018

Introduction

This case will comprehensively examine two potential career launching-points: Nashville, TN and Chicago, IL. These cities vary greatly in size, climate, industries, culture, and cost of living. The research done in this case made clear the differences between the two cities and sparked careful thought regarding where to live as I begin to work full-time. Such thought will ultimately lead to a decision on where to launch a career. This case offers factors that someone ought to consider when choosing where to begin a career in accounting.

A. City Climate and Topography

Nashville and Chicago vary greatly in size. Chicago's 2017 census data puts its population at over 2.7 million people, compared to Nashville's near-670 thousand census population. While Nashville's population is relatively large (25th largest city by population in the nation), it is only about a quarter of the size of Chicago (2017 Census Data). The cities' climates also vary greatly, as Nashville experiences warm summers and mild winters, with average temperatures reaching 89 degrees in July and falling to 26 degrees in January ("Best Places to Live"). Chicago, on the other hand, reaches 84 degrees in July and plummets to 14 degrees in January ("Climate for Chicago, IL"). Chicago's proximity to Lake Michigan moderates its climate to some extent in the summer, but its winter-time temperatures are far more extreme than Nashville's. Chicago receives nine times as many inches of snow as Nashville. Chicago receives a large amount of

sunshine in the summer, compared to little in the Winter. The humidity of both cities is comparable, averaging around 70 percent in both. However, the humidity is more-so felt in Nashville's hotter summer temperatures, creating a humid subtropical climate.

Chicago originally sat at the bottom of Lake Michigan, which caused its topography to be rather flat. Chicago sits at nearly 600 feet above sea-level. Sand beaches sit along the shore of Lake Michigan (Willman). Tennessee has varied topography across the state. While Nashville sits in what is called the "Central Basin", a low, flat region, a short drive away from the city will take someone to the edge of the "Highland Rim", a region characterized by hills, valleys, and farmland (Littman). Nashville and Chicago have similar, flat topographies in the cities, but Nashville's surrounding areas have more varied topography than Chicago. Note in the photographs (Figures 5-1 and 5-2), that both cities appear to be on flat ground, but rolling hills paint the background of the Nashville skyline, while the background of the Chicago skyline is flat.

Figure 5-1: Chicago Skyline

©Getty Images / zrfphoto 1

Figure 5-2: Nashville Skyline

Courtesty https://www.cbre.us

B. Getting Around

Transportation in the two cities is extremely different. Chicago residents have public transportation readily available to them. Chicago has the nation's second largest public transportation system, with 144 rail stations over town connecting over 40 communities ("Getting Around Chicago"). Nashville, on the other hand, has minimal public transportation available. Commutes to work in Nashville would consist of vehicular commutes ranging from 15 to 45 minutes, depending on distance and traffic. Commutes in Chicago range from 30 minutes to an hour on cars, buses, or trains. Additionally, travel home from Chicago to home in Nashville by air would take one and a half hours, nine hours by car. Assuming a downtown Nashville living location, driving home to see family would only take 20 minutes.

C. Prevalent Industries

The prevalent industries in the two cities vary widely. Healthcare, automobile production, finance, higher ed, insurance, and music production industries dominate Nashville ("Nashville Statistics and Demographics"). In Chicago, manufacturing, printing and publishing, finance, insurance, and food processing dominate ("Chicago: Economy"). Both cities have excellent healthcare partly due to the prevalence of prestigious universities and research institutions in both cities. Chicago and Nashville both are on the cutting edge of innovation in medical research and care. Universities such as University of Chicago and

Northwestern have specific innovation and startup funds which promote progress in the medical research field. Chicago has over 26 thousand healthcare related companies, a 70-billion-dollar industry (Dietsche). No matter the city, Chicago or Nashville, world-class healthcare will be accessible

D. Living

Chicago has obtained a poor reputation regarding criminal activity. However, criminal activity is highly centralized to western and southern sides of Chicago. It is necessary to be diligent no matter where in large city like Chicago, but dangerous areas can be avoided. The website, neighborhoodscout.com, attributes a crime index of eight out of 100 to Chicago, but surprisingly only a six out of 100 to Nashville. This means that Chicago, IL is safer than eight percent of US cities, while Nashville is safer than only six percent. Areas to avoid in Nashville include East Nashville and Antioch. Violent crimes occur in Chicago at a rate of 11.15 out of 1000 people and at a rate of 11.62 out of 1000 in Nashville. Property crimes occur at a rate of 39.13 out of 1000 people in Nashville, compared to 32.56 out of 1000 in Chicago ("Neighborhood Scout"). Surprisingly, at a per capita rate, Nashville's crime statistics are fairly like Chicago's. Prior to research, crime rates were acting as a hinderance to living in Chicago. However, with due diligence in commutes and living, safety in Chicago is not a major issue.

On deciding where to live in Nashville and Chicago, three factors need be considered: crime level, distance from city-center, and rent prices. Nashville rents tend to be lower than Chicago's on average. Chicago rent hovers around an

average rate of $1,808 compared to Nashville's average rate of $1,275 ("RENTCafe"). Three Chicago neighborhoods stood out with these factors taken into consideration: Edison Park, Evanston, Clarendon Hills. Rents in the three areas hover around $1,200 to $1,700 per month. The cheapest of the three options is Edison Park, the most expensive being Evanston. Both neighborhoods sit on the Eastern side of the city. Clarendon Hills is more of a suburban area, northwest of the city. Assuming a $50,000 salary, having a roommate to split the cost of rent would be necessary in Nashville and in Chicago. With rents, crime rates, and proximity to downtown considered, Nashville has better living options than Chicago. While Nashville rents have grown over the past decade, it is easier to live closer to the city-center for cheaper and safer in Nashville than it is in Chicago. Below are affordable living options in Chicago and Nashville (Zillow, Inc.):

Figure 5-3: Affordable Chicago Living

Figure 5-3 (contd.)

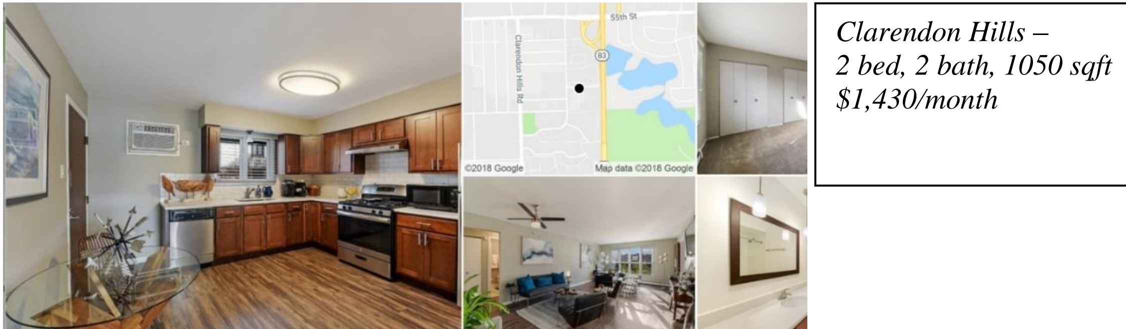
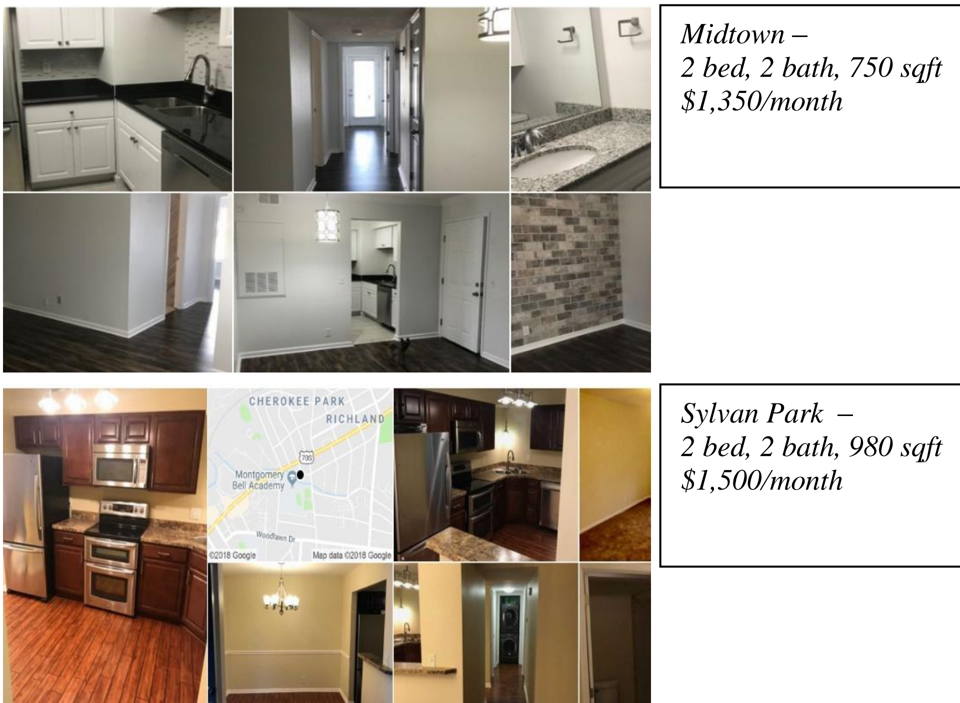


Figure 5-4: Affordable Nashville Living



All units sampled had either shared laundry in the buildings or laundry machines in the individual units. While an in-unit laundry set up would be ideal, it is not a deal-breaker. In Chicago, Jewel-Osco, Whole Foods, and ALDI supermarkets can be found near most areas. It is also common in Chicago to stumble upon small, family-owned grocery stores. Nashville has Publix, Kroger,

and Harris-Teeter supermarkets in most areas. Nashville has mostly chain supermarkets with few family-owned stores.

E. Lifestyle

How free time is spent in a respective city will play a large role in determining ultimate satisfaction with living in a city. Fortunately, both cities are ripe with entertainment and charitable/religious in which to spend and invest one's time. Both cities have professional football, basketball, hockey, baseball, and soccer teams. Nashville has a Minor League but not a Major League Baseball (MLB) franchise, while Chicago has two. In a few years, Nashville will have a Major League Soccer team and Chicago already has one. Both cities have plenty of live music venues. Chicago has popular spots such as the Navy Pier and Millennium Park, while Nashville has plenty of scenic parks outside of the city.

Intriguing religious and charitable organizations in Nashville include: Habitat for Humanity, Westminster Presbyterian Church, and Preston Taylor Ministries. Habitat for Humanity is an organization which organizes volunteers to build homes on weekends for those in need. Westminster Presbyterian Church is a large church near downtown Nashville which attracts people from various areas of Nashville. Preston Taylor Ministries is an after-school program which provides children in low-income areas with tutoring and mentor relationships.

Intriguing religious and charitable organizations in Chicago include: Second Presbyterian Church Chicago, Bridge Communities, Inspiration Corporation. Second Presbyterian Church Chicago is a medium-size Presbyterian

church in Chicago. Bridge Communities is a non-profit organization which houses, mentors, and empowers homeless families, with the goal of moving the families toward self-sufficiency ("Bridge Communities – Who We Are"). Inspiration Corporation is a similar organization that caters more toward homeless individuals, not just families. No matter the city, there will be plenty of different ways to spend free time.

F. Cost of Living

Chicago has a higher cost of living than does Nashville, essentially due to its high taxes. Illinois has a flat, five percent income tax across the state, while Tennessee does not have a state income tax. Chicago's property taxes sit at around two percent, while Nashville's ranges from around 2.8 percent to 3.2 percent of the assessed value (25 percent of the appraised value) depending on proximity to the downtown district. Sales taxes in Chicago sit around 10 percent, while Nashville's sits at nine percent. Food and groceries in Chicago are subject to an additional two percent tax (SmartAsset).

Although accounting starting salaries are far above average when compared to other careers, living off $50,000 to $60,000 per year requires careful budgeting and planning. Different cities cost different amounts to live in. In order to make an informed decision on where to live immediately after college, it is important to investigate the differences in costs of living in different cities. Chicago and Nashville have extremely different costs of living, as the personal operating budgets in Figures 5-5 and 5-6 demonstrate.

Figure 5-5: Operating Budget – Chicago

Monthly Income		$5,000
Taxes:		
Federal Income (15.23%)	761.63	
State Income (4.95%)	247.50	
Total Taxes		1009.13
FICA:		
Social Security	310	
Medicare	73	
Total FICA withholdings		383
Take-Home Pay		3,607.87
Rent		800
Fuel Cost		121.83
Utilities		121.16
Internet		40.14
Food		500
Health Insurance		244
Car Insurance		93.88
401(k) Contribution		250
Discretionary Income		**1,436.86**

Figure 5-6: Operating Budget – Nashville

Monthly Income		$5,000
Taxes:		
Federal Income (15.23%)		761.63
FICA:		
Social Security	310	
Medicare	73	
Total FICA Withholdings		383
Take-Home Pay		3,855.37
Rent		600
Fuel Cost		61.50
Utilities		132.76
Internet		40.14
Food		500
Health Insurance		225
Car Insurance		61.46
401(k)		250
Discretionary Income		**1,984.51**

**Taxes and FICA, Internet, Utilities via SmartAsset; Rent via RENTCafe averages; Fuel cost est. with Edmunds.com; health insurance est via valuepenguin.com; auto insurance est via quotewizard.com; 401k via KPMG benefits plan*

Due to higher rents, insurance costs, total fuel costs (due to longer driving distances), and taxes, Chicago's cost of living is significantly higher than Nashville's, resulting in over $500 less of discretionary income than could be expected in Nashville. When making $5,000 per month, an extra $500 in personal expenses amounts to an extra ten percent of income that is lost when living in Chicago. This budget does not consider the over one percent higher sales tax in Chicago compared to Nashville. Therefore, discretionary income in Nashville would go farther than it would in Chicago.

Conclusion

After extensively researching facts related to Chicago and Nashville, I could still see myself living in both cities. However, due to the lower cost of living, warmer climate, and smaller size, Nashville has emerged as my favorite. Having grown up in Nashville, seeking out new opportunities and new experiences in Chicago is still intriguing. For this reason, I am still considering Chicago as an initial launching point, with Nashville in mind as a landing place ten years or so after launching a career. As expenses increase with starting a family, Nashville's lower cost of living would be financially easier to raise a family. This case study, while not accounting-centric, does provide analysis that is necessary to consider when beginning to launch a career.

Case Six

Capitalized Costs versus Expenses

16 November 2018

Introduction

This case will explore the fraudulent errors in WorldCom, Inc.'s accounting that led to its historic fall as a company in the early 2000s. Analysis of WorldCom, Inc.'s accounting failures demonstrates the differences between what constitutes an asset (capitalized cost) and what constitutes an expense and why correct categorization of an asset or an expense is severely important for external users of financial statements. This case study of WorldCom will demonstrate how financial statement users interpret assets differently than expenses. Additionally, this case demonstrates the impacts and consequences of the mischaracterization of an asset for the balance sheets, income statements, and statement of cash flows.

A. Assets and Expenses

According to the FASB Statement of Concepts No. 6, paragraph 25, assets are defined as "probable future benefits obtained or controlled by a particular entity as a result of past transactions or events." According to paragraph 80 of the same statement, "Expenses are outflows or other using of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations" (FASB).

An cost would be recorded as an asset if three characteristics of the expenditure are present, according to the FASB Statement of Concepts No. 6: (1) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net

cash inflows, (2) a particular entity can obtain the benefit and control others' access to it, and (3) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred (FASB). As an organization consumes a resource, it recognizes an expense. If the costs do not provide future benefit to the organization in cash flows, then the company must recognize the costs as expenses. According to the GAAP expense recognition principle, expenses should be recognized so that they are matched with the revenues to which they are related. Costs related to assets are capitalized, then gradually expensed over the asset's useful life via amortization or depreciation as the organization benefits from the asset.

B. What Becomes of "Costs" After Their Initial Capitalization

When costs are capitalized, they are added to an asset account. Therefore, when initially incurred, the costs appear on the balance sheet as opposed to expenses on the income statement. However, these capitalized costs will eventually make their way to the income statement as depreciation expense in future periods. Instead of the costs hitting the income statement all at once as period costs, the costs will gradually hit the income statement over the course of the useful life of the asset for which the costs were capitalized. Capitalizing expenses results in higher bottom lines in the periods in which they are incurred.

C. WorldCom, Inc. Statement of Operations – Line Costs

For the year ended December 31, 2001, WorldCom reported line costs of $14.739 Billion on its Statement of Operations(Figure 6-1). The journal entry for these costs are as follows (in millions):

	Debit	Credit
Line Cost	14,739	
Cash		14,739

WorldCom paid these line costs to other telecommunication providers to gain access to their infrastructure and networks. These costs immediately hit the income statements in the form of expenses. This entry increases expenses, decreases income, decreases assets (cash), and decreases equity.

Figure 6-1: WorldCom, Inc. Consolidated Statement of Operations (as reported) for the Year Ended December 31, 2001

WORLDCOM, INC. AND SUBSIDIARIES
STATEMENT OF OPERATIONS
(In Millions, Except Per Share Data)

	For the Years Ended December 31,			
		2000		**2001**
Revenues	$	39,090	$	35,179
Operating Expenses:				
Line costs		15,462		14,739
Selling, general and administrative		10,597		11,046
Depreciation and amortization		4,878		5,880
Other charges		-		-
Total		30,937		31,665
Operating income		8,153		3,154
Other income (expense):				
Interest expense		(970)		(1,533)
Miscellaneous		385		412
Income before income taxes, minority interests and cumulative effect of accounting change	$	7,568	$	2,393
Provision for income taxes		3,025		927
Income before minority interests and cumulative effect of accounting change	$	4,543	$	1,466
Minority interests		(305)		35
Income before cumulative effect of accounting change	$	4,238	$	1,501
Cumulative effect of accounting change (net of income tax of $50 in 2000)		(85)		-
Net income	$	4,153	$	1,501

**The above WorldCom, Inc. Consolidated Statement of Operations (Figure 6-1) was obtained from the U.S. Securities and Exchange Commission's online EDGAR database (WorldCom, Inc. F3) and provided in the thesis as a reference for analysis performed in case study six.*

D. Improperly Capitalized Costs

It was later revealed after WorldCom released their 2001 financial statements that WorldCom improperly capitalized some of their line costs and that

the line cost income statement account should have been much larger than $14 billion in 2001 (Figure 6-1). According to the Wall Street Journal article, the once-booming telecommunications market became over-saturated around 2001 and left the market with excess capacity in fiber-optic networks (Sandberg and Blumenstein). WorldCom took advantage of this excess capacity by leasing access to third-parties' telephone lines. This access was used to carry the calls of WorldCom's customers. Therefore, to properly match the expenses incurred by these lease agreements to revenues generated by this additional capacity, the costs should have been expensed immediately. Additionally, since these individual lease payments were not providing WorldCom with future benefit, they should have been expensed as incurred, rather than capitalized and amortized.

E. Impacts of Improper Capitalization on WorldCom Balance Sheet and Statement of Cash Flows

"Transmission equipment" on WorldCom's Balance Sheet increased by $3.526 billion between 2000 and 2001 (Figure 6-2), as WorldCom began to inappropriately capitalize line costs. These costs incorrectly appear under Property and Equipment. WorldCom received only access to and not ownership of the third-parties' networks through their contractual arrangements. Since the line costs were unjustly classified as investments in property, plant, and equipment, WorldCom understates its cash flows from investing activities. The line costs should have impacted the operating section of the cash flow statement and therefore the capitalization overstates the cash flows from operating activities.

Figure 6-2: WorldCom, Inc. Consolidated Balance Sheet (as reported) for the Year Ended December 31, 2001

WORLDCOM, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(In Millions, Except Per Share Data)

	For the Years Ended December 31,	
	2000	**2001**
ASSETS		
Current assets:		
Cash and cash equivalents	$761	$1,416
Accounts receivable, net of allowance for bad debts of $1,532 in 2000 and $1,086 in 2001	6,815	5,308
Deferred tax asset	172	251
Other current assets	2,007	2,230
Total current assets	9,755	9,205
Property and Equipmet:		
Transmission equipment	20,288	23,814
Communications equipment	8,100	7,878
Furniture, fixtures, and other	9,342	11,263
Construction in progress	6,897	5,706
	44,627	48,661
Accumulated depreciation	(7,204)	(9,852)
Goodwill and other intangible assets	46,594	50,537
Other assets	5,131	5,363
Total Assets	$ 98,903	$ 103,914
LIABILITIES AND SHAREHOLDERS' INVESTMENT		
Current liabilities:		
Short-term debt and current maturities of long-term debt	$ 7,200	$ 172
Accrued interest	446	618
Accounts payable and accrued line costs	6,022	4,844
Other current liabilities	4,005	3,576
Total current liabilities	17,673	9,210
Long-term liabilities, less current portion:		
Long-term debt	$ 17,696	$ 30,038
Deferred tax liability	3,611	4,066
Other liabilities	1,124	576
Total long-term liabilities	22,431	34,680
Minority interests	2,592	101
Company obligated mandatorily redeemable and other preferred securities	798	1,993
Shareholders' investment:		
WorldCom, Inc. common stock, par value $.01 per share; authorized: 5,000,000,000 shares in 2000 and none in 2001; issued and outstanding: 2,887,960,378 shares in 2000 and none in 2001	29	-
WorldCom group common stock, par value $.01 per share; authorized: none in 2000 and 4,850,000,000 shares in 2001; issued and outstanding : none in 2000 and 2,967,436,680 shares in 2001	-	30
MCI group common stock, par value $.01 per share; authorized: none in 2000 and 150,000,000 shares in 2001; issued and outstanding: none in 2000 and 118,595,711	-	1
Additional paid-in capital	52,877	54,297
Retained Earnings	3,160	4,400
Unrealized holding gain (loss) on marketable equity securities	345	(51)
Cumulative foreign currency translation adjustment	(817)	(562)
Treasury stock, at cost, 6,765,316 shares of WorldCom, Inc. in 2000, 6,765,316 shares of	(185)	(185)
Total shareholders' investment	55,409	57,930
Total liabilities and shareholders' investmentA51:A54	$ 98,903	$ 103,914

**The WorldCom, Inc. Consolidated Balance Sheet (Figure 6-2) was obtained from the U.S. Securities and Exchange Commission's online EDGAR database (WorldCom, Inc. F4) and provided in the thesis as a reference for analysis performed in case study 6.*

The improper capitalization journal entries over the course of the year (summarized in Figure 6-3) increased property and equipment assets (transmission equipment) and decreased current assets (cash). Unlike the entry to line costs illustrated in Part C, equity was not affected by the entry (Figure 6-3) in the period in which it is capitalized. It will impact equity in later periods by way of depreciation expense

Figure 6-3: Summarization of Journal Entries Related to the Improper Capitalization of Line Costs

Account	Debit	Credit
Transmission Equipment	3,055,000,000	
Cash		3,055,000,000

F. 2001 Depreciation Related to Improperly Capitalized Line Cost Expenditures

When capitalized, the costs in question appear on the income statement in 2001 in the amount of $83 million as depreciation expense (Figure 6-4), which pales in comparison to the $3.055 billion that should have been expensed and charged to line costs by a debit to line costs (expense) instead of transmission equipment (asset) in Figure 6-3.

Figure 6-4: Calculation of Depreciation

Depreciation Equation for Quarter *n* Expenditures:

$$\frac{\text{Expenditure Amount}}{\text{Midpoint of Range for Transmission Equipment } (\frac{40-4}{2}+4)} * [\text{ portion of year depreciated } (\frac{4-n+1}{4} \text{ quarters})\ ]$$

Quarter 1 Expenditures: \$771 Million / 22 years * $\frac{4}{4}$ quarters = \$ 35.045 Million

Quarter 2 Expenditures: \$610 Million / 22 years * $\frac{3}{4}$ quarters = 20.795 Million

Quarter 3 Expenditures: \$743 Million / 22 years * $\frac{2}{4}$ quarters = 16.886 Million

Quarter 4 Expenditures: \$931 Million / 22 years * $\frac{1}{4}$ quarters = 10.580 Million

2001 Depreciation Related to Improper Capitalizations $ 83.306 Million

2001 Depreciation Entry:

Account	Debit	Credit
Depreciation Expense	83,306,000	
Accumulated Depreciation – Transmission Equipment		83,306,000

G. Analysis of Restated Income Statement (Figure 6-5) versus Original Income Statement (Figure 6-1)

The difference between WorldCom's corrected net income (Figure 6-5) and its originally reported income (Figure 6-1) is certainly material. WorldCom reported a net income of $1.5 billion in 2001 (Figure 6-1). The improper capitalizations understated line costs by $3.055 billion (Figure 6-3), overstated depreciation and amortization expense by $83.306 million (Figure 6-5), and overstated income taxes by $695 million. Once these adjustments are made, WorldCom's bottom line plummets from a $1.5 billion income (Figure 6-1) to a $776 million loss (Figure 6-5). These improper accounting practices resulted in a

$2.276 billion overstatement in net income. This is a grossly material overstatement that severely impacted investors, employees, and the market.

Figure 6-5: WorldCom's Restated Income Statement, with Line Costs, Depreciation, and Income Taxes Appropriately Adjusted

WorldCom, Inc. And Subsidiaries
Consolidated Statements of Operations (In Millions)
For the Years Ended December 21, 2001

Revenues	35,179
Operating Expenses:	
Line Costs (a)	17,794
Selling, General, and Administrative	11,046
Depreciation and amortization	5,797
Total	34,720
Operating Income	542
Other Income (expense):	
Interest Expense	(1,533)
Miscellaneous	412
Loss before income taxes and minority interests	(579)
Income Tax (b)	(232)
Loss before minority interests	(811)
Minority Interests	35
Net Income (c)	(776)

Line Costs: 14,739 (Figure 6-1) - 17,794 (a) = $3,055 million

Income Tax Expense: 927 (Figure 6-1) – 232 (b) = ($695 million)

Net Income: 1,501 (Figure 6-1) - (776) (c) = $2,276 million

Conclusion

This case study demonstrated the snowball effect that a mischaracterization of expenses as capitalized costs causes. Even though the $3.055 billion in line costs were represented on WorldCom's financial statements, representing them in the wrong section (assets instead of expenses) makes an over $2 billion difference in Income. This case also demonstrated the significance of the timing of expense recognition. By not recognizing the expenses as incurred, WorldCom pushed them off to succeeding periods by means of depreciation expense. Although expenses related to the line costs were eventually recognized as depreciation expense, the mistiming of this recognition exponentially inflated WorldCom's income in 2001. This case study of WorldCom illustrated the devastating shockwaves that are sent out by the misapplication of accounting principles.

Case Seven

Financial Statement Interpretation and Analysis

6 March 2019

Introduction

The objective of this case is three-fold. The first objective is to become familiar with a set of financial statements including auditor opinions and significant accounting policy footnotes. The second objective is to perform a basic analysis and interpretation of the financial statements and balance sheets. The last objective is to recognize the role of estimation in the preparation of financial statements. To accomplish these objectives, this case will use and analyze Starbucks Corporation and its financial statements from the fiscal year ended 2013.

A. Nature of Starbucks's Business

Starbucks purchases and roasts high-quality coffees that it sells, along with handcrafted coffee and tea beverages and a variety of fresh food items, through its company-operated stores. It also sells a variety of coffee and tea products and licenses its trademarks through other channels such as licensed stores, grocery and national foodservice accounts (Starbucks Corporation 48). It categorizes its operations by Company-operated Stores, Licensed Stores, Consumer Packaged Goods, and Foodservice. Starbucks' primary source of revenue comes from sales in its Company-operated retail stores (79 percent of total net revenues in 2013). Product sales to and royalty and license fee revenues from Starbucks' licensed stores are the next largest source of revenue nine percent of total net revenues, and consumer packaged goods sold to grocery stores, etc. accounted for seven percent of total net revenues. Starbucks controls "purchasing, roasting and packaging, and the global distribution" of coffee used in its

operations (Starbucks Corporation 7). Therefore, Starbucks' business can be described as that of retail (company-operated stores) and supply/marketing (licensed stores, consumer packaged goods, foodservice).

B. Consolidated Financial Statements Overview

Typically, companies prepare in their annual 10-k reports the US Securities Exchange Commission (SEC) the following: Income Statement (Including Comprehensive Income if applicable), Balance Sheet, Statement of Cash Flows, Statement of Stockholders' Equity and notes to the financial statements. Starbucks provides the following titles for these statements: Consolidated Statements of Earnings (Consolidated Income Statement), Consolidated Statements of Comprehensive Income, Consolidated Balance Sheets, Consolidated Statements of Cash Flows. The "Consolidated" title is necessary when a company owns a greater than 50 percent stake in another company. In a consolidated statement, Starbucks reflects its financial position and operating results by including its wholly owned subsidiaries and investees which Starbucks controls or has significant influence over.

C. Financial Statement Reporting

Publicly traded corporations are required to prepare quarterly reports (10-Q), annual reports (10-K), and a report when a significant business event occurs, such as an acquisition, in an 8-K report. These filings are regulated by the SEC in the United States.

D. Financial Statement Uses

Financial statements are prepared internally by Starbucks management and verified externally by an independent public accounting firm. Additionally, the CEO and CFO bear the ultimate responsibility for the validity of the statements, as they are required to sign off on the report as required by The Sarbanes-Oxley Act of 2002.

The financial statements are primarily used by shareholders of the company. Since the shares of the company are traded in a public market, companies are required to provide the financial statements by the SEC. Current and potential shareholders will be interested in the company's earnings (especially the earnings per share). Investors will also be interested in knowing balance sheet information such as the liquidity (ability to easily turn assets into cash) and solvency (ability to meet long-term obligations) of the company.

Additionally, creditors will use these reports before lending money to Starbucks. Potential lenders will look for companies with high solvencies to lend money to, in order to minimize bad debt expenses that may arise from the debtor failing to fulfill its obligations.

Financial statement users will investigate the notes to the financial statements in addition to the financial statements to obtain a greater understanding of the company's financial standing and performance than the financial statements alone could provide.

E. External Audit

Deloitte & Touche LLP are Starbucks' external auditors and provided two opinion letters to Starbucks in 2013.

In the first letter, Deloitte's Seattle office assumes the responsibility of expressing an opinion on Starbucks' financial statements, based on its audits. Deloitte makes the important distinction that while it is its responsibility to provide a responsible opinion on the financial statements, the financial statements themselves are the responsibility of Starbucks' management. Deloitte makes clear that its audits are based on the standards as put forth by the Public Company Accounting Oversight Board (PCAOB). Finally, Deloitte's Seattle office issues an opinion that Starbucks' consolidated financial statements present fairly the financial position of Starbucks Company and its subsidiaries, as of September 29, 2013 (Starbucks Corporation 77).

In the second letter, Deloitte issues an opinion on Starbucks' internal controls as required by the PCAOB's auditing standards. Deloitte establishes that the expressed opinion on Starbucks' internal controls are Deloitte's responsibility, while the internal controls themselves are the responsibility of Starbucks. Deloitte's internal control audit is guided by *Internal Control – Integrated Framework (1992)*. Deloitte defines internal controls and its limitations. Finally, Deloitte issues the opinion that "in all material respects, effective internal control over financial reporting as of September 29, 2013" (Starbucks Corporation 79).

These opinions are issued several months after Starbucks' fiscal year end

(Sept. 29), because the audit takes place after the preparation of Starbucks' financial statements as of year-end.

F. Starbucks Balance Sheet Analysis (Balance Sheet – Figure 7-2)

i. Assets = Liabilities + Equity

Total liabilities are 61 percent of total assets and total equity is 39 percent of total assets, so combined they equal 100 percent of assets (Figure 7-2). Therefore, total liabilities and equity are equal to total assets, and Starbucks accounting equation balances.

ii. Asset Analysis

For 2013, the three largest categories of assets are property, plant and equipment, net (28 percent); cash and cash equivalents (22 percent); and inventories (10 percent) (Figure 7-2). Current assets are 48 percent of total assets, and noncurrent assets are 52 percent (Figure 7-2). Property, plant and equipment being the largest category of assets is certainly appropriate for a company like Starbucks, who owns over 10 thousand stores across the world (Starbucks Corporation 4). It is also appropriate that Starbucks would have a nearly equal share of current and noncurrent assets, since Starbucks owns a lot of property, plant and equipment, but also must maintain large levels of inventories and cash as a retail business.

iii. Intangible Assets Analysis

Intangible assets are non-financial instruments that lack physical existence (Kieso 614). Starbucks reports goodwill as the excess of the price paid by Starbucks over the fair value of the net assets of previously-acquired businesses. Goodwill is obtained only when Starbucks purchases another company but can become impaired. Starbucks reports goodwill as 7.49 percent of its total assets and other intangible assets as 2.39 percent of total assets. These other intangible assets likely include trademarks that Starbucks holds over its merchandise. Total intangible assets equal nearly ten percent of Starbucks's total assets.

iv. Starbucks Financing Analysis

Starbucks is financed 61.08 percent by liabilities and 38.92 percent by equity. Long-term debt counts as 11.28 percent of total assets, while contributed capital from owners counts as only 2.46 percent of total assets. Non-owners primarily finance Starbucks' operations by issuing Starbucks debt, as shown in Figure 7-1.

Figure 7-1: Starbucks Corporation Financing

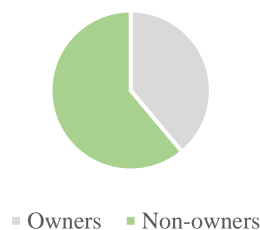


Figure 7-2: STARBUCKS CORPORATION
COMMON-SIZE CONSOLIDATED BALANCE SHEETS
(in millions, except per share data)

	Sep. 29, 2013	Sep. 30, 2012
Assets		
Current assets:		
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%
Total current assets	47.51%	51.09%
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%
Goodwill	7.49%	4.86%
TOTAL ASSETS	100.00%	100.00%
Liabilities and Equity		
Current liabilities:		
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%
Total current liabilities	46.69%	26.89%
Long-term debt	11.28%	6.69%
Other long-term liabilities	3.11%	4.20%
Total liabilities	61.08%	37.77%
Shareholders' equity:		
Common stock ($0.001 par value) - authorized, 1,200.0 shares; issued and outstanding, 753.2 and 749.3 shares (includes 3.4 common stock units), respectively	0.01%	0.01%
Additional paid-in capital	2.45%	0.48%
Retained earnings	35.86%	61.40%
Accumulated other comprehensive income	0.58%	0.28%
Total shareholders' equity	38.90%	62.16%
Noncontrolling interests	0.02%	0.07%
Total equity	38.92%	62.23%
TOTAL LIABILITIES AND EQUITY	100.00%	100.00%

**Starbucks Corporation's Balance Sheet (above) was obtained from The U.S. Securities and Exchange Commission's EDGAR Database and then made into a common-size statement by dividing all assets, liabilities, and equity by total assets, liabilities, and equity respectively (Starbucks Corporation 47).*

G. Starbucks Revenue Recognition

Starbucks follows accrual accounting. Starbucks recognizes revenues at the point of sale for company-operated stores, because they transfer goods and earn revenue at the point of sale. In the case of in-store transactions, there is little difference between cash and accrual revenue recognition principles. Starbucks recognizes revenues from licensed stores "upon shipment to licensees, depending on contract terms" which indicates Starbucks subscription to the accrual accounting method for revenue recognition. Starbucks records outstanding balances on gift cards as unearned revenue and recognizes revenue on the stored value cards when the cards are presented for payment or when the "likelihood of redemption, based on historical experience is deemed to be remote" (Starbucks Corporation 52).

H. Starbucks Expense Analysis

Cost of sales including occupancy costs (43 percent) and store operating expenses (29 percent) account for a combined 72 percent of total net revenues (Figure 7-3). Occupancy costs are primarily rents, which would make sense that this would be a major expense for Starbucks. With so many stores across the world, its rent costs will naturally be very high. Especially since Starbucks has multiple stores in major cities, where rents are high. Cost of sales includes food and drink materials costs, so Starbucks high expense in this area falls in line with the nature of Starbucks's business.

Figure 7-3: STARBUCKS CORPORATION
COMMON-SIZE CONSOLIDATED STATEMENTS OF EARNINGS
(in millions, except per share data)

	12 Months Ended	
	Sep. 29, 2013	**Sep. 30, 2012**
Net revenues:		
Company-operated stores	79.19%	79.21%
Licensed stores	9.14%	9.10%
CPG, foodservice and other	11.67%	11.69%
Total net revenues	100.00%	100.00%
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%
Operating income	(2.19%)	15.02%
Interest income and other, net	0.83%	0.71%
Interest expense	(0.19%)	(0.25%)
Earnings before income taxes	(1.54%)	15.48%
Income taxes	(1.60%)	5.07%
Net earnings including noncontrolling interests	0.06%	10.41%
Net earnings attributable to noncontrolling interest	0.00%	0.01%
Net earnings attributable to Starbucks	0.06%	10.40%
Earnings per share - basic	0.00%	0.01%
Earnings per share - diluted	0.00%	0.01%
Weighted average shares outstanding:		
Basic	749.3	754.4
Diluted	762.3	773.0
Cash dividends declared per share	0.01%	0.01%

**Starbucks Corporations Income Statement was obtained from The U.S. Securities And Exchange Commission's EDGAR Database and then made into a common-size statement (above) by dividing all revenues and expenses by total revenues (Starbucks Corporation 45).*

I. Cost Structure Changes

Most costs for Starbucks were consistent across 2012 and 2013. However, in 2013 Starbucks incurred a litigation charge that accounted for 18.7 percent of Starbucks' total revenues (Figure 7-3). This significant charge ultimately resulted in Starbucks' operating loss of 2.19 percent of total net revenues for 2013. This litigation charge resulted from litigation with Kraft Foods Global, Incorporated (Starbucks Corporation 21).

J. Litigation Charge

Starbucks's ligation charge resulting from its arbitration with Kraft was indicated separately, because it is an unusual expense that is not typically incurred as a general and administrative expense. Due to the matching principle set forth by GAAP, which states that expenses should be recognized so that they match revenues, Starbucks must recognize this litigation charge as an operating expense.

K. Profitability Analysis

Starbucks reported net earnings attributable to Starbucks of $8.3 million in 2013 and $1.3 billion in 2012 (Figure 7-4). Starbucks reported an operating loss of $325 million in 2013, down from its operating income around $2 billion in 2012 (Figure 7-4). Since Starbucks was operating at a loss in 2013, it was not profitable. The large litigation charge of $2.784 billion related to arbitration with Kraft is the sole reason that Starbucks was not profitable in 2013 (Starbucks

Corporation 18). Starbucks should return to earning a profit in 2014 barring any other major events. The company earned a net income of $8.3 million only because of a $238.7 million tax break that it received. Starbucks's loss before taxes was $229.9 million (Figure 7-4). If a company cannot generate a profit through its core operations, then it is not a profitable company. Largely, Starbucks is a profitable company, but it was not in 2013 due to the litigation charge related to the conclusion of its litigation with Kraft.

Figure 7-4: Starbucks Corporation
Consolidated Statements Of Earnings (USD $)
(In Millions, except Per Share data, unless otherwise specified)

	12 Months Ended		
	Sep. 29, 2013	**Sep. 30, 2012**	**Oct. 02, 2011**
Net revenues:			
Company-operated stores	$11,793.20	$10,534.50	$9,632.40
Licensed stores	1,360.50	1,210.30	1,007.50
CPG, foodservice and other	1,738.50	1,554.70	1,060.50
Total net revenues	14,892.20	13,299.50	11,700.40
Cost of sales including occupancy costs	6,382.30	5,813.30	4,915.50
Store operating expenses	4,286.10	3,918.10	3,594.90
Other operating expenses	457.20	429.90	392.80
Depreciation and amortization expenses	621.40	550.30	523.30
General and administrative expenses	937.90	801.20	749.30
Litigation charge	2,784.10	-	-
Total operating expenses	15,469.00	11,512.80	10,175.80
Gain on sale of properties	-	-	30.20
Income from equity investees	251.40	210.70	173.70
Operating income	(325.40)	1,997.40	1,728.50
Interest income and other, net	123.60	94.40	115.90
Interest expense	(28.10)	(32.70)	(33.30)
Earnings before income taxes	(229.90)	2,059.10	1,811.10
Income taxes	(238.70)	674.40	563.10
Net earnings including noncontrolling interests	8.80	1,384.70	1,248.00
Net earnings attributable to noncontrolling interest	0.50	0.90	2.30
Net earnings attributable to Starbucks	$8.30	$1,383.80	$1,245.70
Earnings per share - basic	$0.01	$1.83	$1.66
Earnings per share - diluted	$0.01	$1.79	$1.62
Weighted average shares outstanding:			
Basic	749.3	754.4	748.3
Diluted	762.3	773	769.7
Cash dividends declared per share	$0.89	$0.72	$0.56

**Starbucks Corporation's Statement of Earnings (Figure 7-4) was obtained from The U.S. Securities and Exchange Commission's EDGAR Database and provided in the thesis as a reference for analysis performed (Starbucks Corporation 43).*

L. Starbucks Statement of Cash Flows Analysis

i. Net Earnings versus Net Cash

Starbucks's net cash provided by operating activities was $2,908.3 million in 2013 (Figure 7-5). When preparing a statement of cash flows, companies arrive at net cash provided by operating activities by adjusting net earnings by adding back non-cash expenses and adjusting for changes in operating assets and liabilities. The figure that created the large disparity between cash flows from operating activities and net earnings was the Kraft litigation charge of $2.784 billion accrued in 2013. Additionally, since depreciation and amortization are significant non-cash expenses, the $655.6 million in depreciation and amortization expenses (Figure 7-5) also contribute significantly to the difference between cash provided by operating activities and net income.

ii. PP&E Cash Analysis

Starbucks used $1.15 billion in cash in 2013 for investments in property, plant, and equipment (Figure 7-5). This amount is up around $300 million from the figure in 2012.

iii. Dividends Analysis

Starbucks paid $629 million in cash for dividends in 2013 (Figure 7-5). Starbucks declared $668.6 million in dividends in 2013 according to its Consolidated Statements of Equity (Starbucks Corporation 47). The disparity between dividends declared and dividends paid is accounted for

in Starbucks's $38.4 million increase in "Accrued dividend payable" noted in note 7 to Starbucks's financial statements which details accrued liabilities (Starbucks Corporation 63).

When Starbucks declares a dividend, it will make the following entry (in millions):

		Debit	Credit
Cash Dividends Declared		668.6	
	Cash Dividends Payable		668.6

Once Starbucks pays its cash dividends, it will then later make the following entry (in millions):

		Debit	Credit
Cash Dividends Payable		629	
	Cash		629

Due to differences in timing of the declaration and payment of dividends, cash paid for dividends as presented on the statement of cash flows and the amount of dividends declared in the statement of stockholders' equity will not exactly line up.

Figure 7-5: STARBUCKS CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in millions)

	For 12 Months Ended Sept 29, 2013	Sept 30, 2012
OPERATING ACTIVITIES:		
Net earnings including noncontrolling interests	8.80	1,384.70
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	655.60	580.60
Litigation charge	2,784.10	0.00
Gain on sale of properties	0.00	0.00
Deferred income taxes, net	(1,045.90)	61.10
Income earned from equity method investees, net of distributions	(56.20)	(49.30)
Gain resulting from sale/acquisition of equity in joint ventures	(80.10)	0.00
Stock-based compensation	142.30	153.60
Other	23.00	23.60
Cash provided/(used) by changes in operating assets and liabilities:		
Accounts receivable	(68.30)	(90.30)
Inventories	152.50	(273.30)
Accounts payable	88.70	(105.20)
Accrued liabilities and insurance reserves	87.60	23.70
Deferred revenue	139.90	60.80
Prepaid expenses, other current assets and other assets	76.30	(19.70)
Net cash provided by operating activities	2,908.30	1,750.30
INVESTING ACTIVITIES:		
Purchase of investments	(785.90)	(1,748.60)
Sales, maturities and calls of investments	1,040.20	1,796.40
Acquisitions, net of cash acquired	(610.40)	(129.10)
Additions to property, plant and equipment	(1,151.20)	(856.20)
Proceeds from sale of property, plant, and equipment	15.30	5.30
Proceeds from sale of equity in joint ventures	108.00	0.00
Other	(27.20)	(41.80)
Net cash used by investing activities	(1,411.20)	(974.00)
FINANCING ACTIVITIES:		
Proceeds from issuance of long-term debt	749.70	0.00
Principal payments on long-term debt	(35.20)	0.00
(Payments)/proceeds from short-term borrowings	0.00	(30.80)
Purchase of noncontrolling interest	0.00	0.00
Proceeds from issuance of common stock	247.20	236.60
Excess tax benefit from exercise of stock options	258.10	169.80
Cash dividends paid	(628.90)	(513.00)
Repurchase of common stock	(588.10)	(549.10)
Minimum tax withholdings on share-based awards	(121.40)	(58.50)
Other	10.40	(0.50)
Net cash used by financing activities	(108.20)	(745.50)
Effect of exchange rate changes on cash and cash equivalents	(1.80)	9.70
Net increase/(decrease) in cash and cash equivalents	1,387.10	40.50
CASH AND CASH EQUIVALENTS:		
Beginning of period	1,188.60	1,148.10
End of period	$ 2,575.70	$ 1,188.60
Cash paid during the period for:		
Interest, net of capitalized interest	$ 34.40	$ 34.40
Income taxes	$ 539.10	$ 416.90

**Starbucks Corporation's Balance Sheet (above) was obtained from The U.S. Securities and Exchange Commission's EDGAR Database and then made into a common-size statement by dividing all assets, liabilities, and equity by total assets, liabilities, and equity respectively (Starbucks Corporation 47).*

M. Starbucks's Use of Estimates

Starbucks uses estimates to calculate impairment of assets and goodwill, stock-based compensation forfeiture rates, future asset retirement obligations, inventory, and depreciation and amortization, allowance for doubtful accounts. Cash and cash equivalents are estimate-free, Accounts receivable and Accounts payable gross (exclusive of allowances for doubtful accounts) will be estimate-free. Property, Plant, and Equipment gross (exclusive of depreciation) will also be recorded at cost and estimate free.

Conclusion

This case's three objectives, as laid out in the introduction, were to become familiar with public company financial statements, perform basic analysis of the financial statements, and to recognize the role of estimates in financial statement preparation. In Parts A through E, I explored the parts of the financial statements and their role in providing financial statement users with useful information. My analysis uncovered the owner-dominant financing structure of Starbucks and the cause of the operating loss in fiscal year 2013 in a litigation charge. I also discovered the numerous estimates that Starbucks uses in part I. This case study allowed me to interact with financial statements to better understand how to read and analyze corporate financial information. This is a skill that I will carry far into my public accounting career.

Case Eight

Contingent Liabilities

3 April 2019

Introduction

This case study investigates contingent liabilities through the example of the BP Deep Horizon Spill that occurred off the Gulf Coast in 2010. Since contingent liabilities require significant judgement, they pose significant challenges to auditors. Estimates are not only more risky accounts, but they also are often causes of disputes between auditors and management as the two parties may arrive at different conclusions about the appropriate amount for a contingency.

Better understanding contingent liabilities will better equip me to carry out my duties as an auditor both on my internship in Winter 2020, as well as when I begin full-time. The critical analysis and study provided by this case study into contingent liabilities will arm me to better assess clients' contingent liability assertions. This case examines how contingent liabilities arise, different types of contingent liabilities, and managerial judgments that must be made in recording contingencies. BP's Deep Horizon Spill offers an excellent case for which to examine all of these factors.

A. Contingent Liabilities

A contingent liability is a liability incurred as a result of probable future losses that have arisen from current actions. Contingent liabilities are recorded only when it is both probable that a liability has been incurred, and the amount of the loss can be reasonably estimated. The existence of the liabilities are contingent upon uncertain factors, such as litigation outcome or the occurrence of an event. Examples of contingent liabilities are litigation claims, warranty costs,

environmental liabilities.

Companies do not record gain contingencies in the body of the financial statements. However, if it is very likely that a contingent asset exists, then the company will disclose the gain contingency. Contingent assets are not recorded, while contingent liabilities are, due to the FASB principle of conservatism, which says that when in doubt companies should overestimate losses and underestimate gains by accounting for the "worst-case" scenario.

B. BP Product Warranty – Telescopic Joint Purchased from GE

In the case of a piece of equipment such as a telescopic joint, which BP purchases from GE Oil and Gas, both GE and BP have product warranties related to this equipment. For BP, the product warranty related to the joint will be disclosed in the footnotes to the financial statements, but it will not be recorded as an asset.

For GE Oil and Gas, the warranty related to the joint is an assurance-type warranty. GE will estimate the cost of the assurance-type warranty over its life and record a contingent liability for the estimated costs remaining related to the warranty at the end of the year. In the case of the telescopic joint sale between GE and BP, the assurance-type warranty does not create a separate performance obligation for GE, as the warranty costs are included in the price of the telescopic joint. The contingent liability of warranty costs will be realized by GE Oil and Gas if BP discovers defects on the telescopic joint within the two-year life of the

warranty. The warranty liability account will be adjusted based on changes in estimates of the contingent costs.

C. Management Judgements Related to Product Warranties

For contingent liabilities in general, management must consider "the amount payable, the payee, the date payable, or its existence" (Kieso 674). Most importantly management must determine the likelihood that a contingency exists. If it is highly likely that the company will eventually absorb a loss directly resulting from prior actions by the company, then the management will acknowledge a contingent liability if the amount of the liability can be reasonably determined.

For warranties, management must first determine the nature of the warranty. If the warranty is only a guarantee that the product sold will perform as expected (for a certain period), then it is an assurance-type warranty. If the warranty is a sold-separate promise to offer a service or coverage beyond an assurance-type warranty, then it is a service-type warranty. Take for example a car purchase: if a car manufacturer's warranty is included in the sales price, then the manufacturer will shoulder any costs of repairs within a set amount of mileage on the car. If the car buyer purchases an extended warranty, then the car manufacturer will cover costs of certain repairs beyond the standard mileage. The consideration for a service warranty will often be payed up-front and recognized as unearned warranty revenue during the period that the service warranty (not the assurance warranty) covers. In addition, management must determine the number

of potential defects that will arise in the sold products over the life of the warranty (based on statistical analysis) and the costs of repairs for such defects.

A warranty claim differs from the contingent liability which arises from an incident such as the Deep Horizon Spill in that warranty claims are typically easier to estimate than is the spill's liability. When a company offers an assurance warranty as a portion of the sales price, it allows itself to estimate and plan for possible defects in its equipment. BP was not able to as easily prepare for such a contingent cost, as BP was forced to liquidate assets to raise $30 billion for a disaster relief fund to handle the recovery costs and contingent liabilities that arose from the spill (Gyo). Also, warranties typically don't have as damaging of an effect on the financial statements of businesses as does the Deep Horizon Spill. For example, in 2017 GE (the company who sold the telescopic joint) reported expenditures of $827 million related to commitments, guarantees, product warranties and other loss contingencies (General Electric Company 183). It is estimated that BP has incurred nearly $145 billion in costs in the aftermath of the oil spill (Gyo).

D. Contingent Liability Estimation – Deepwater Horizon Oil Spill

In note 36 of BP's 2011 annual report, BP breaks provisions relating to the Gulf of Mexico Oil Spill into four broad categories: environmental, spill response, litigation and claims, and clean water act penalties (BP p.I.c 232). BP must estimate potential fines that it might incur based on environmental laws. Significant legislation, such as the Oil Pollution Act of 1990 and Clean Water Act

dictate many of environmental penalties. For litigation, BP must estimate the probability that litigation filed against BP will result in restitution by BP to the respective parties. This can be done with the help of legal counsel. BP may also reference litigation related to the Exxon Valdez Spill to estimate the outcomes of these suits. BP must estimate the cost of clean-up related to the oil spill that it will likely by law have to pay. If the amounts or likelihood of materialization are uncertain or inestimable, then BP does not need to record a contingent liability.

According to the Downs Law Group, a Gulf Coast law firm, class action lawsuits can be broken into medical benefits and property damages. According to Downs, cleanup workers, Zone A residents (people living on specified beachfront areas for at least 60 days between April and September 2010 who have been diagnosed with a specific condition), or Zone B residents (people living on specified wetland or bayou areas for 60 days between April and September 2010). Property damages are those related to items such as business economic loss, individual economic loss, or physical damage to property (Downs Law Group). In addition to these civil lawsuits are federal and state lawsuits. To draw a boundary around potential lawsuits, the damages incurred by those filing against BP must have suffered direct damages from the spill. An example of this requirement is illustrated by the medical benefits. To qualify for medical benefits from BP, plaintiffs must have been in the area of the spill, for the 60 days during which the spill was most severe and have a specific condition that could have arisen directly from the pollution. Businesses that may be able file against BP would be commercial fishing businesses, bayside businesses, and even states. The State of

Alabama filed a lawsuit "seeking damages for alleged economic and environmental harms" (BP p.I.C 162). BP acknowledges that "there is significant uncertainty in the extent and timing of costs and liabilities relating to the incident," but appears to be very diligently estimating amounts (BP p.I.c 59). BP discloses at-length its legal proceedings on pages 160 through 163 of its 2011 annual report. It appears that the contingent liability is being accounted for accurately and effectively, given that BP is accounting for all environmental, litigation, and clean-up contingencies.

Conclusion

This case study allowed critical analysis into how contingent liabilities arise, the different types of contingent liabilities, and the judgements that go into contingent liability estimations through the lens of British Petroleum's Deep Horizon oil spill. Before this case I knew of the oil spill, but it was intriguing to explore the financial impact to BP as a company through the resulting contingent liabilities. This case study demonstrated how contingencies arise – when events occur (oil spill) such that a liability (lawsuit and criminal penalties) is probable and estimable. Additionally, this case demonstrates the different forms that contingent liabilities take, such as product warranties or lawsuits, and that lawsuits tend to be much costlier liabilities than warranties do. Finally, this case study demystified how management estimates contingent liabilities. BP considered a multitude of damages that they would be held liable for by assessing the impact of the oil spill with the consultation of a law firm. This careful analysis and study of contingent liabilities has granted me a greater understanding of the

nature of contingent liabilities. This understanding is essential for a career in audit, because as a high-risk account, contingent liabilities are frequently scrutinized and tested extensively in audits to ensure proper expense recognition.

Case Nine

Equity Method Investments

10 April 2019

Introduction

This case study examines accounting for equity-method investments by examining Wendy's Company's investment in Tim Hortons. Both Wendy's and Tim Hortons are fast food companies. Wendy's Company's joint-venture investment is referred to throughout this case study as TimWen. This case analyzes equity-method investments' impacts on the investing company's balance sheet, statement of cash flows, and the income statement. Additionally, this case will investigate how equity-method investments derive their values as presented on the investing company's books, and why the carrying value often deviates from the book value of the invested-in company. Since companies often make equity-method investments, substantial understanding of equity-method investments and their impacts on financial statements will be useful for a career in audit.

A. Reasons Companies Enter Joint-Venture Arrangements

There are several advantages to entering a joint-venture arrangement. By entering a joint-venture, companies can create synergies and expand their capabilities at a quicker and more efficient rate than they could on their own without such an arrangement. According to Northern Ireland Business Info's website, benefits of joint-venture agreements include: "access to new markets and distribution networks, increased capacity, sharing of risks and costs with a partner, and access to greater resources" ("Guide Joint ventures and business partnerships."). These benefits arise under the assumption that the companies in the agreement are compatible and have the right business relationship. Also,

equity method investments allow significant influence over a company's operations without having to expend the resources necessary to buy out a company.

B. Equity Method Accounting Overview

If an investor purchases ownership of a company through the purchase of shares of common stock, then the extent to which the investor can influence the managerial decisions of the investee will determine the accounting treatment. If the company purchases less than a 20 percent ownership stake in the company (less than 20 percent of shares outstanding), then the company accounts for its investment at fair value. The fair value of the investment is the price at which the investment could be readily sold by the investing company in the market.

For an investor with significant influence over a company, accounting for the investment at fair value and only recognizing the investee's dividends does not accurately convey the investor's relationship with the investee's profits. For instance, if an investor exerts significant influence over a company and that company incurs a loss, but pays out dividends, then the investor's books will not reflect any loss and only income from the dividend. For an investor with significant influence over an investee, this recognition is misleading.

If the investor purchases between a 20 and 50 percent ownership stake in the investee and can assert "significant control" over the investee, then the investor accounts for the investment with the equity method. Under the equity method, the company accounts for the investment at the acquisition cost (the price

paid for the shares). Under the equity method, the investor does not adjust the carrying value of the investment to its fair value. The investing company instead recognizes a portion of the investee's income in proportion to the investor's ownership stake. The investor's share of income appears on the investor's books in the nonoperating section of the income statement and on the balance sheet as an increase in the investment account. The investor recognizes its share of income because of the investing company's significant stake in the investee and the investor's ability to significantly influence the operations of the investee.

When the investee pays dividends to the investor, the investor decreases the investment account by its share of dividends. Dividend payments by the investee to the investor decreases the investment account because dividends are a return to the investor of its own portion of income. Additionally, with significant influence, the investor can direct dividend payments. This method significantly differs from the fair value method (less than 20 percent investments) in that the fair value method recognizes income of the investee only through dividend payments received.

For investments in over 50 percent of a company's ownership shares, the investor is said to have a controlling interest and the investor and investee prepare consolidated income statements. For a company with 20 to 50 percent ownership of an investee, consolidated statements overstate the influence of the investor on the investee.

C. Accounting for Excess of Investment Amount over Book Value of Underlying Net Assets

The excess of the investment amount over the investor's share of the investee's book value (total assets-total liabilities) is known as the Acquisition Accounting Premium (AAP). Under the equity method, the AAP is allocated to the investee's total assets by writing the assets up to fair value. The AAP consists of two pieces: (1) the portion used to write up net identifiable assets and liabilities to fair value and (2) goodwill. Although companies used to amortize goodwill, as of 2001 goodwill is no longer amortized but rather periodically tested for impairment. The write up of net identifiable assets and liabilities to fair value occurs through an increase to the equity investments account on the investor's books, since the assets and liabilities of the investee are not on the investor's books.

D. Equity Method Investments on Wendy's Company's Balance Sheet

Wendy's included on its 2011 and 2012 balance sheets investment amounts of $113.3 million and $119.3 million respectively (Figure 9-1). Equity method investments appear on the investor's balance sheet in the "investments" asset account. Wendy's Company's joint venture with Tim Horton's (THI) and Japan are its only Equity Investments. However, the $1.750 million credit balance in the Japan JV equity investment account represents a liability Wendy's books, since Wendy's has agreed to finance future cash requirements of the Japan JV, according to note 8 of Wendy's financial statements (Figure 9-2a). When

amortizing excess of purchase price (AAP), Wendy's debits equity income and credits Equity Investment.

Figure 9-1: The Wendy's Company
Consolidated Balance Sheets (USD $)
For the Year Ended Dec. 30, 2012
(In Thousands, unless otherwise specified)

	Dec. 30, 2012	Jan. 01, 2012
Current assets:		
Cash and cash equivalents	$453,361	$475,231
Accounts and notes receivable	61,164	68,349
Inventories	13,805	12,903
Prepaid expenses and other current assets	24,231	27,397
Deferred income tax benefit	91,489	80,970
Advertising funds restricted assets	65,777	70,547
Total current assets	709,827	735,397
Properties	1,250,338	1,192,200
Goodwill	876,201	870,431
Other intangible assets	1,301,537	1,304,288
Investments	113,283	119,271
Deferred costs and other assets	52,013	67,542
Total assets	4,303,199	4,289,129
Current liabilities:		
Current portion of long-term debt	12,911	6,597
Accounts payable	70,826	81,301
Accrued expenses and other current liabilities	137,348	178,298
Advertising funds restricted liabilities	65,777	70,547
Total current liabilities	286,862	336,743
Long-term debt	1,444,651	1,350,402
Deferred income taxes	438,217	458,107
Other liabilities	147,614	147,808
Commitments and contingencies		
Stockholders' equity		
Common stock, $0.10 par value; 1,500,000 authorized; 470,424 shares issued	47,042	47,042
Additional paid-in capital	2,782,765	2,779,871
Accumulated deficit	(467,007)	(434,999)
Common stock held in treasury, at cost	(382,926)	(395,947)
Accumulated other comprehensive income	5,981	102
Total stockholders' equity	1,985,855	1,996,069
Total liabilities and stockholders' equity	$4,303,199	$4,289,129

**The Wendy's Company's Balance Sheet was obtained from U.S Securities and Exchange Commission EDGAR database (The Wendy's Company 58).*

Figure 9-2: Excerpts from Footnote 8 to the Financial Statements

Figure 9-2a: Wendy's Equity Investments (in thousands)	**Year End**			
		2012		**2011**
Equity investments:				
Joint venture with THI	$	89,370	$	91,742
Joint venture in Japan (a)		(1,750)		77
Cost investments:				
Arby's		19,000		19,000
Jurlique		—		325
Other cost investments		4,913		8,127
	$	111,533	$	119,271

(a) In 2012, our equity investment in the Japan JV was included in "Other liabilities;" Wendy's has provided certain guarantees and the partners have agreed on a plan to finance anticipated future cash requirements of the Japan JV as further described below.

Figure 9-2b: TimWen's Balance Sheet Information (in thousands)	**Year End**			
		2012		**2011**
Balance sheet information:				
Properties	$	73,013	$	73,394
Cash and cash equivalents		3,538		2,621
Cash and cash equivalents		3,274		4,231
Other		2,516		2,565
	$	82,341	$	82,811
Accounts payable and accrued liabilities	$	3,215	$	2,281
Other liabilities		8,561		8,655
Partners' equity		70,565		71,875
	$	82,341	$	82,811

Figure 9-2c: Activity Related to Equity Investment in TimWen (in thousands)

	Year Ended	
	2012	2011
Balance at beginning of period	$ 91,742	$ 98,631
Equity in earnings for the period	13,680	13,505
Amortization of purchase price adjustments	(3,129)	(2,934)
	10,551	10,571
Distributions received	(15,274)	(14,942)
Foreign currency translation adjustment included in "Other comprehensive income (loss), net"	2,351	(2,518)
Balance at end of period	$ 89,370	$ 91,742

**All of the above information in Figure 9-3 was obtained from U.S Securities And Exchange Commission EDGAR database (The Wendy's Company 77).*

E. Carrying Value of The Wendy's Company's Investment in TimWen

Wendy's investment in TimWen at year-end 2012 is $89.37 million (Figure 9-2a). On TimWen's books, net assets are equal to $70.57 million (Figure 9-2b). Wendy's Co.'s share of TimWen's net assets (50 percent) is equal to $35.28 million. The difference in Wendy's share of TimWen's net assets at cost ($35.28 million) and Wendy's recorded investment in TimWen ($89.37 million) is due to the Acquisition Accounting Premium. The net assets are recorded on TimWen's books at cost. However, Wendy's did not pay only the cost of TimWen's net assets for its investment. The investment account also grows due to recognition of TimWen's income and the investment account decreases as

Wendy's receives dividends, amortizes the AAP, and increases or decreases based on foreign currency translation.

F. Equity Income Analysis

i. Impact of Wendy's Equity Method Investment in TimWen on Earnings Before Taxes in 2011 and 2012

In 2012 and 2011, the effect of Wendy's equity method investment in TimWen on Wendy's income increases income by $10.551 million and $10.571 million respectively (Figure 9-2c). These amounts are comprised of equity earnings for both periods, less the amortization of purchase price adjustments. These amounts are buried in "Other operating expense, net" on Wendy's consolidated statement of operations. The equity income from all Wendy's equity investments (not just Tim Hortons) is calculated in Figure 9-3. Wendy's Company's total equity income is less than its income from its TimWen due to the losses attributable to the Japan JV (Figure 9-3).

Figure 9-3: Equity Income from Wendy's Equity Investments (numbers in thousands)

Equity in earnings from investment in TimWen's	13,680
Amortization of purchase price adjustment - TimWen	(3,129)
Equity in losses for the period – Japan JV	(1,827)
Equity income (buried in other operating expenses, net)	8,724

ii. Journal Entry to Record Wendy's Share of TimWen's 2012 Earnings (in thousands)

(Numbers from Figure 9-3)

Equity Investments	13,680	
Equity Income		13,680

iii. Journal Entry to Record the Amortization of the Purchase Price Adjustments for 2012

The amortization of the purchase price adjustments for 2012 equaled $3.129 million (Figure 9-3). The entry for this amortization would be as follows (in thousands):

Equity Income	3,129	
Equity Investments		3,129

iv. Journal Entry to Record the Wendy's Receipt of Dividends from TimWen for 2012

Wendy's received $15.724 million in dividends from TimWen, as noted in note 8 to the financial statements (Figure 9-2a), as well as in the statement of cash flows as "Distributions received from TimWen Joint Venture". The journal entry for these dividends received would be as follows (in thousands):

Cash	15,724	
Equity Investments		15,724

G. Wendy’s Company Statement of Cash Flows Analysis

i. Cash Flows from Operating Activities – Adjustment for “Equity in earnings in joint ventures, net”

Most commonly, companies arrive at cash flows from operating activities in the statement of cash flows is to use the indirect method – which starts with net income and adjusts net income from an accrual basis to a cash basis. The $8.724 million under “Equity in earnings in joint ventures, net” (Figure 9-4) is Wendy’s share of TimWen’s earnings (50 percent), net of the purchase price adjustment amortization. These earnings have been accrued by Wendy’s but not necessarily realized in cash. Therefore, to adjust to the cash basis for the statement of cash flows, the accrued earnings must be backed out of net income.

The adjustment figure in the statement of cash flows ($8.724 million) is uncoincidentally the same value as the equity income figure derived in Figure 9-3 in part F(i).

Figure 9-4: The Wendy's Company
Consolidated Statement of Cash Flows - Operating Activities (USD $)
(In Thousands, unless otherwise specified)

	12 Months Ended	
	Dec. 30, 2012	**Jan. 01, 2012**
Cash flows from operating activities:		
Net income (loss)	$9,467	$9,875
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	154,174	145,302
Loss on early extinguishment of debt	75,076	-
Distributions received from TimWen joint venture	15,274	14,942
Share-based Compensation, Including Portion Attributable to Discontinued Operations	11,473	17,688
Impairment of long-lived assets	21,097	14,441
Net (recognition) receipt of deferred vendor incentives	(920)	7,070
Accretion of long-term debt	7,973	8,120
Amortization of deferred financing costs	4,241	6,216
Non-cash rent expense	7,210	7,554
Loss on disposal of Arby's	442	8,799
Equity in earnings in joint ventures, net	(8,724)	(9,465)
Deferred income tax	(31,598)	1,624
Deferred Income Tax Expense (Benefit), Including Portion Attributable to Discontinued Operations		
Operating investment adjustments, net	(27,769)	(145)
Other, net	3,093	2,999
Changes in operating assets and liabilities:		
Accounts and notes receivable	3,999	(2,690)
Inventories	(561)	(517)
Prepaid expenses and other current assets	(1,360)	(7,580)
Accounts payable	(9,266)	11,364
Accrued expenses and other current liabilities	(42,906)	11,120
Net cash provided by operating activities	190,415	246,717

**All of the above information in Figure 9-4 was obtained from U.S Securities and Exchange Commission EDGAR database (The Wendy's Company 79).*

ii. Cash Flows from Operating Activities – Adjustment for "Distributions received from Joint Venture"

A positive adjustment is made to net income under the operating activities section of the Statement of Cash Flows for distributions received from the joint venture. The positive adjustment for dividend distributions is made, because Wendy's does not recognize the dividend distributions as net income under the equity method. However, distributions from its share of TimWen's income in the form of dividends do constitute operating activities. Therefore, in order to adjust from the accrual base of income from operating activities to the cash basis, dividends received must be added to income. The amount of "Distributions received from joint venture" in the statement of cash flows (Figure 9-4) is equal to the amount of "distributions received" as presented in note 8 (Figure 9-2). Tim Horton's Inc. was Wendy's only source of dividend distributions in 2012, as Japan JV Wendy's other equity investment) did not issue any dividends.

Conclusion

This case study unpacked Wendy's equity-method investment in a joint venture with Tim Horton's. Analysis of Wendy's carrying amount of the Tim Horton's investment versus Wendy's share of Tim Horton's book value found that Wendy's had an unamortized Accounting Acquisition Premium (AAP) of over $50 million related to its Tim Horton's investment. Wendy's Company's total Wendy's Company's investment in TimWen increased its bottom line by over $10 million for 2011 and 2012. However, Wendy's investment in a Japanese joint venture cost its bottom line nearly $2 million in

2012. Wendy's Company's equity method investment in TimWen accounted for $89.37 million of its total assets at the end of 2012 – recorded under "investments" on the balance sheet.

Although the TimWen investment requires a negative adjustment to net income to arrive at cash flows from operating activities in the statement of cash flows, this does not mean that the investment is eating cash and is therefore not a cause for concern. The adjustment simply reflects that the income realized in the investment has not yet turned to cash. Due to TimWen's positive impact on Wendy's Company's net income, assets, and its premium value, the investment in the joint venture with Tim Horton's was viable for Wendy's Company as of 2012.

Case Ten

Pension Plan Accounting

18 April 2019

Introduction

While many companies are slowly moving from using pension plans to 401(k)s as their retirement benefits for employees, pension plans still do exists and due to their complex nature are worth studying. Pension plans also present an intriguing case study on the nature of liabilities and how they arise. This case study examines pensions through the example the Johnson & Johnson company, which used a pension plan as of 2007. This case will study defined-benefit pension plans specifically, investigating how and when liabilities arise in defined-benefit pension plans, how different events impact the benefit obligation and plan assets, as well as how assets are used to satisfy pension obligations. An enhanced understanding of pensions will arm me with a greater understanding of accounting for retirement benefits, as well as a better understanding for liabilities, as pensions are a rather unique liability that requires a greater deeper understanding of liabilities.

A. Differences Between the Defined Benefit and Defined Contribution Retirement (Pension) Plans

Defined benefit plans prescribe what the participants of the plan will be entitled to receive once they retire. The employee's retirement entitlement is the responsibility of the employer. The employer will contribute to an independent pension fund that will go toward meeting the retirement obligation. The pension liability, called the projected benefit obligation, is based on an actuarial assumption that determines the vested and non-vested benefits based on future salaries. The difference between the projected benefit obligation and fair value of the pension assets (the amount that the employer has contributed to the plan) is reported on the employer's books as an asset if the fair value of the employer's contributions exceeds the projected benefit obligation, and a liability if the projected benefit obligation exceeds the fair value of the contributions.

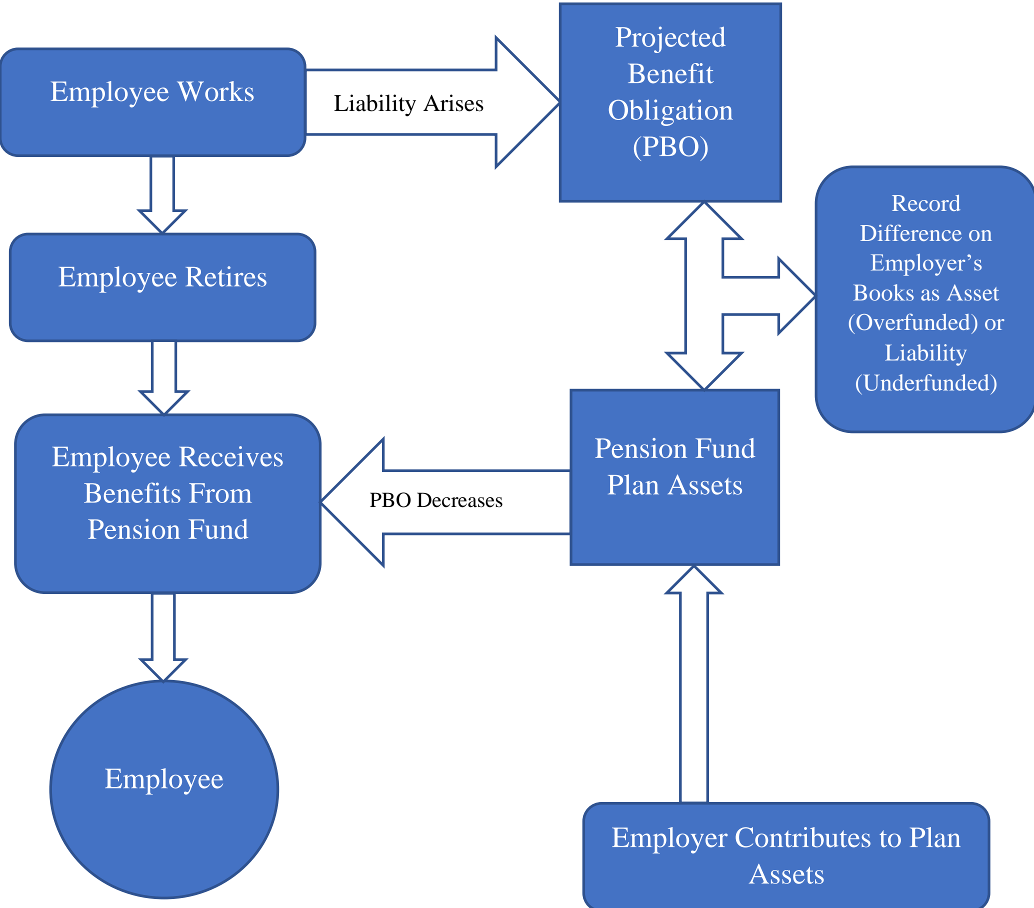
Defined contribution plans prescribe the contributions that the employer must make to the pension plan. The only obligation that the employer has under the defined contribution plan is the obligated contribution, so accounting for defined contribution plans is much simpler than accounting for defined benefit pension plans.

B. Why Retirement Plan Obligations are Liabilities

The below flowchart (Figure 10-1) demonstrates the accounting for pension plans from the conception of the obligation as the employee works for the company, to when the employee retires and receives benefits from the pension

plan. The flowchart demonstrates where and how the liability arises, as well as how it decreases. As the employee works, the company becomes liable to pay the employee's future retirement benefits, which is why the projected benefit obligation is a liability to the company.

Figure 10-1: Pension Plan Flowchart



C. Assumptions Necessary to Account for Retirement Plan Obligations

The necessary assumptions in accounting for retirement plans are related to the projected benefit obligation and the pension assets. Assumptions needed for the projected benefit obligation are calculated by actuaries. Actuarial assumptions include assumptions about employees' lifespans, health, life choices, salaries, and futures with company. These actuarial assumptions determine the projected benefit obligation and can change to either increase or decrease the projected benefit obligation. The contributions to the plan assets are invested into very safe market securities that offer returns over the life of the plan assets. The expected return on plan assets is related to market data. The expected return on plan assets will increase the plan assets.

D. Activities that Influence Companies' Pension Obligations

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.

Service cost – service cost is the accrued benefit that the employee is entitled to for his or her work during the current period.

Service Cost JE

	Debit	Credit
Pension Expense	XX	
Projected Benefit Obligation		XX

Interest cost – this is the interest expense that the employer accrues on the projected benefit obligation. The interest rate is known as the settlement rate.

Interest Cost JE

Pension Expense	XX	
Projected Benefit Obligation		XX

Actuarial gains or losses – these are gains or losses that occur as a result of changes in the actuarial assumptions that go into determining the projected benefit obligation. If the change in actuarial assumptions increases the projected benefit obligation, then the employer recognizes an actuarial loss.

Actuarial Loss JE

Pension Expense	XX	
Projected Benefit Obligation		XX

If the change in actuarial assumptions decreases the projected benefit obligation, then the employer recognizes and actuarial gain.

Actuarial Gain JE

Projected Benefit Obligation	XX	
Pension Expense		XX

Benefits paid to retirees – these are the benefits payed to retirees out of the pension fund. This decreases the benefit obligation and plan assets but does not affect Johnson & Johnson's cash, as Johnson & Johnson does not control the Plan Assets.

Retirement Benefits Paid JE

Projected Benefit Obligation	XX	
Plan Assets		XX

E. Activities that Influence Companies' Pension Assets

Actual return on pension investments – The actual return on pension investments is the change in the fair value of the investments, independent of contributions made by the employer and benefits paid by the investment fund.

Company contributions to the plan – These are the contributions paid by the employer to the pension investment fund.

Benefits paid to retirees – These are the benefits paid to the retiree by the pension investment fund. These benefits are owed to the retiree for his or her service provided to the company.

F. Return on Plan Assets

The return on plan assets included in pension expense is the return that was expected to be accrued. The return included in pension plan assets is the return that was accrued by the plan assets over the course of the period. The expected return is used in pension expense in order to smooth earnings. The FASB feared that recognizing the actual return in earnings would make pension expense too volatile. The company will recognize differences between the actual and expected return in other comprehensive income as a gain or a loss. The company will then amortize the balance in other comprehensive income over the average service life of employees if the beginning balance exceeds 10 percent of the larger of the beginning projected benefit obligation and plan assets. This

arbitrary 10 percent amount is known as the amortization corridor. The general entries to record returns on plan assts are as follows:

To record actual return			
Plan Assets		XX	
	Pension Expense		XX
To adjust pension expense to expected return and record gain			
Pension Expense		XX	
	Other Comprehensive Income – G/L		XX
**reverse entry for loss*			
To record amortization of OCI-G/L			
Other Comprehensive Income – G/L		XX	
	Pension Expense		XX

G. Johnson & Johnson Pension Expense Analysis

Johnson & Johnson reported $646 million in net periodic benefit cost for 2007 (Figure 10-2) – this is Johnson & Johnson's pension expense. The entries to record the service cost and interest expense portions of the pension expense are included in Figure 10-2.

Figure 10-2: Johnson & Johnson 2007 Pension Expense Detail and Related Journal Entries

Pension Expense Detail

(Dollars in Millions)	Retirement Plans 2007	2006	2005
Service cost	$ 597	552	462
Interest cost	565	570	488
Expected return on plan assets	(809)	(701)	(579)
Amortization of prior service cost	10	10	12
Amortization of net transition asset	1	(1)	(2)
Recgnized actuarial losses	186	251	219
Curtailments and settlements	5	4	2
Net periodic benefit cost	**$ 646**	**685**	**602**

**The above detail was obtained from Johnson & Johnson's 2007 Annual Report (Johnson & Johnson 61)*

Related Pension Expense Journal Entries (numbers in millions)

To record the service cost

	Debit	Credit
Pension Expense	597	
Projected Benefit Obligation		597

To record interest expense

	Debit	Credit
Pension Expense	565	
Projected Benefit Obligation		565

H. Johnson & Johnson Retirement Plan Obligations (Pension Liability) Analysis

i. Analysis of Johnson & Johnson Retirement Plan Obligation as of December 31, 20017

The value of the retirement plan obligation is $12 billion at December 31, 2007 (Figure 10-3). The retirement plan obligation represents the benefits that are

projected to be owed to employees in the pension plan. The retirement plan obligation number is based on actuarial assumptions, which could change.

Figure 10-3: Johnson & Johnson 2007 Benefit Obligation and Plan Assets Detail

	Retirement Plans	
(Dollars in Millions)	**2007**	**2006**
Change in Benefit Obligation		
Projected benefit obligation - beginning of year	$ 11,660	10,171
Service cost	597	552
Interest cost	656	570
Plan participant contributions	62	47
Amendments	14	7
Actuarial (gains) losses	(876)	(99)
Divestitures & acquisitions	79	443
Curtailments & settlements	(46)	(7)
Benefits paid from plan	(481)	(402)
Effect of exchange rates	337	378
Projected benefit obligation - end of year	**$ 12,002**	**11,660**
Change in Plan Assets		
Plan assets at fair value - beginning of year	$ 9,538	8,108
Actual return on plan assets	743	966
Company contributions	317	259
Plan participant contributions	62	47
Settlements	(38)	(7)
Divestitures & acquisitions	55	300
Benefits paid from plan assets	(481)	(402)
Effect of exchange rates	273	267
Plan assets at fair value - end of year	**$ 10,469**	**9,538**
Funded status at - end of year	**$ (1,533)**	**(2,122)**

**The above detail was obtained from Johnson & Johnson's 2007 Annual Report (Johnson & Johnson 62)*

ii. Analysis of Johnson & Johnson 2007 Pension-Related Interest Cost

The pension related interest cost for 2007 is $656 million (Figure 10-3). Given the projected benefit obligation at the beginning of 2007 of $11.66 billion (Figure 10-3), the interest rate used by Johnson & Johnson is 5.6 percent, as computed below (figures in millions):

$$\left(\frac{656}{11{,}660}\right) * 100 = 5.6\%$$

The calculated rate of 5.6 percent is realistic, since the discount rate for international plans is 5.5 percent and the rate for U.S. benefit plans is 6.5 percent (Figure 10-4). The presumed discount rate used by Johnson and Johnson of 5.6 percent falls between the U.S. Benefit Plans and International Benefit Plans discount rates (Figure 10-4). This makes sense as Johnson & Johnson has operations and employees both in the U.S. and in international countries.

Figure 10-4: Discount Rates Used to Develop Actuarial Present Value of Projected Benefit Obligation

(Dollars in Millions)	Retirement Plans 2007
U.S. Benefit Plans	
Discount rate	6.50%
International Benefit Plans	
Discount rate	5.50%

**The above percentages were obtained from Johnson & Johnson's 2007 Annual Report (Johnson & Johnson 61)*

iii. Pension Benefits Paid to Johnson & Johnson Retirees in 2007

Johnson and Johnson's pension plan payed $481 million to retirees in 2007 (Figure 10-3). Johnson and Johnson did not directly pay the retirees. Johnson & Johnson made cash contributions to the pension plan which was held and controlled by a trustee, and the trustee then payed the benefits to the retirees out of the pension plan's assets. The pension plan is an independent entity from Johnson and Johnson. The benefits payed reduce the retirement plan obligation and retirement plan assets by equal amounts.

To record benefits paid to retirees (in millions)

	Debit	Credit
Projected Benefit Obligation	481	
Plan Assets		481

I. Johnson & Johnson Retirement Plan Assets at December 31, 2007

The value of Johnson & Johnson's plan assets at fair value at December 31, 20017 is $10,469 million (Figure 10-3). This is the fair value of Johnson and Johnson's accumulated contributions to the pension plan, net of disbursements, at the end of 2007. Johnson & Johnson does not hold this amount in any of it accounts, but rather an independent trustee holds the retirement plan assets. Therefore, this amount does not appear on Johnson & Johnson's Balance Sheet and can only be found in the notes to the financial statements. Rather, the difference between the plan assets and Johnson & Johnson's projected benefit obligation appear on the Balance Sheet.

i. Expected versus Actual Return on Plan Assets

The expected returns on plan assets for 2006 and 2007 as stated under pension expense were $701 million and $809 million respectively (Figure 10-2). The actual returns for the same years were $966 million and $743 million respectively (Figure 10-3). In 2006, there was a gain of $265 million that arose from the excess of actual returns over expected. In 2007, there was a loss of $66 million that arose from the excess of expected returns over actual returns. The difference in 2006 was very significant, while the difference in 2007 was relatively less significant. The shift from a $265 million gain one year to a $66 million loss the very next year illustrates the volatile nature of returns on plan assets and pension expense. Actual returns more accurately illustrate the economics of the company's pension expense in the short-run, but the shifts likely

offset in the long-run, so the company records pension expense based on expected returns to smooth the volatility of pension expense.

ii. 2007 Retirement Plan Contributions

Johnson & Johnson contributed $259 million and $317 million in 2006 and 2007 respectively (Figure 10-3). Johnson & Johnson employees contributed $47 million and $62 million in 2006 and 2007 respectively (Figure 10-3). Johnson & Johnson contributed 22 percent more to the plan in 2007 than in 2006, while its employees contributed 32 percent more in 2007 compared to 2006. Since Johnson & Johnson's obligation for the pension plans is tied to the retirement distributions, its contributions to the plan can vary year to year. If it was a defined contribution plan, Johnson & Johnson would likely have more consistent year-to-year pension plan contributions. Due to the existence of an employee contribution, Johnson & Johnson likely has a combined contribution plan, where the employer and employee both contribute to the employee's retirement plan.

iii. Retirement Plan Assets Portfolio

Johnson & Johnson's retirement plan assets include both debt and equity securities. The company's international plan includes real estate and other investments. Most retirement plans (US and International) consist of equity securities.

iv. Over(under)funded Status of Johnson & Johnson's Retirement Plan

In 2006, the pension plan was underfunded by $2.122 billion and underfunded by $1.533 billion in 2007 (Figure 10-3). The funded status appears under "employee related obligations" on the company's balance sheet. Since the

fund is underfunded, Johnson & Johnson will record a liability on its balance sheet for the value of the pension plan's underfunded amount.

Conclusion

In pension plans, companies incur a liability to pay employees during retirement while the employees provide services to the company. The company does not wait until the employee retires to recognize the liability, because the employer with a pension plan is liable to pay out retirement benefits as soon as the employee works for the employer. Think of it this way – the employee works in exchange for (1) salaries and wages, and (2) the company's promise to pay the employee during retirement. The promise to pay retirement benefits is a part of the employee's current bargain for their provided services to the company.

The pension obligation does not go away until the employee retires and receives benefits from the pension fund – not when the employer contributes to the pension plan. Accounting for pension plans reinforces the idea that liabilities arise as soon as a company has an obligation to provide a future benefit to a party, and the liability is not liquidated until the promised future benefit is transferred to the party.

Due to the large size of Johnson & Johnson, and the sheer length of time the pension liabilities stay on the books (from the first day of work until retiree benefits are paid out), it is no surprise that Johnson & Johnson has a $12 billion obligation related to its pension (Figure 10-3). Johnson & Johnson will not liquidate this obligation until it does away with its pension plan and the rest of the retirees' benefits are paid out. Luckily for Johnson & Johnson, this large liability does not directly appear on its balance sheet

but rather its plan assets are netted against the liability and the over/underfunded status appears on its books. The staying nature of pension plans is another good reason to study how pensions operate, since companies that are transitioning to 401(k)s from pension plans may have pensions lingering on their books even after pension plans are abandoned.

Case Eleven

New Perspectives on the Balance Sheet Model of Financial Reporting

25 April 2019

Introduction

This case study reviews a paper published by the Center for Excellence in Accounting and Security Analysis at Columbia University, which critiques the balance sheet model of financial reporting. This paper favors the income statement model of reporting over the US Generally Accepted Accounting Principles (GAAP) approved balance sheet model of reporting. The paper provides four critiques regarding the balances sheet approach. These critiques are: (1) reporting should reflect the business model, (2) income is a better measure for the health of a company than assets, (3) earnings are volatile, while the balance sheet is more stable than company operations would often reflect. The income that flows through the assets is what gives most assets their value, and (4) balance sheets include an increasing amount of valuation estimates that calls to question the credibility of the statement (Ilia D. Dichev 2). The paper suggests that financial reporting includes a distinction between operating and financing activities on the balance sheet and income statement. Additionally, it suggests that financial reporting demonstrates a renewed emphasis on the matching principle (Ilia D. Dichev 2). This case study will reflect on ways in which this paper can shift one's perspective, and how this information could be used in a future career in accounting.

A. Shifts in Perspective

Fundamentally, this paper caused me to think more critically about accounting standards. FASB guidelines certainly should always be followed, but discourse surrounding their effectiveness in financial reporting is important for the continual improvement of financial accounting standards. This paper pointed

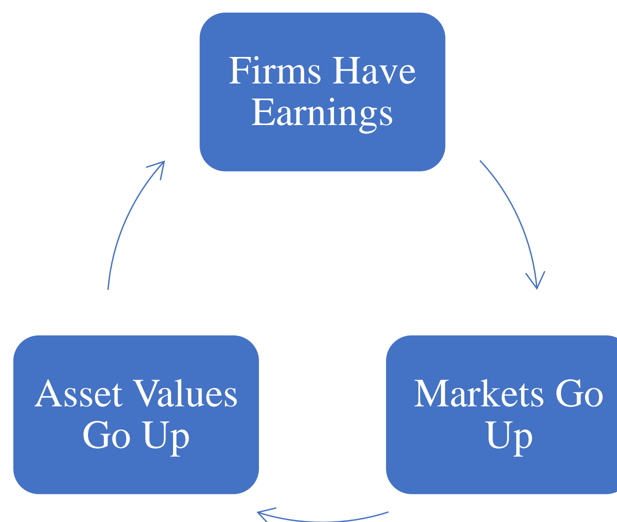
out that the governing body prior to FASB, the Accounting Principles Board (APB), reacted to existing principles accepted by the accounting profession. Conversely, FASB takes a more proactive approach to standard setting (Ilia D. Dichev 5). Although this proactive approach allows FASB to anticipate and prepare for evolving accounting issues, it can also cause the board to set standards that are inconsistent with what many accounting professionals and financial statement users (outside investors, for example) believe to be the most effective and useful. Formal education in accounting principles, as obtained in school and professional workshops, often presents accounting standards as bona-fide law. This is the first time that I have ever encountered such an in-depth critique of FASB standards. Although FASB standards are "law," this paper inspired the realization that they should be subject to critique and analysis.

Additionally, the paper presented an intriguing distinction between "value-in-use" assets and "value-in-exchange" assets. This distinction caused me to change the way I understand assets and their role in companies. The paper argues that, "for most firms the value of their resources from value-in-use and not from value-in-exchange" (Ilia D. Dichev 12). Under the current balance sheet approach adopted by the FASB, undue emphasis is placed on assets in their value-in-exchange. For a lot of companies, the value of most of their assets comes from the assets' uses in generating income and not from their exchange value. According to a study conducted by the authors of the paper, "the use of PPE for internal purposes exceeds the use of PPE for external purposes on a magnitude of 5 to 10 times" and the amount of sales of PPE is only 1 to 2.5 percent of total PPE (Ilia D.

Dichev 13). Prior to reading this article, I understood assets as stores of values, but this paper challenged this belief.

Although the use of fair value estimates in valuing assets has always appeared much more relevant to me than the use of historical cost, Dichev's paper challenges this belief. The balance sheet approach does not allow for a distinction between value-in-use and value-in-exchange assets in financial statements, because income is based on changes in net assets. The income statement approach, rather, bases the value of assets on their use in generating income. To best project earnings, the income statement approach calls for companies to value their operating assets at historical cost (depreciated over the life of the asset), since the historical cost the cost that the company consumed in the attempt to generate revenues. The paper points out that valuing operating assets at fair value inaccurately influences income, creating a feedback loop that dangerously creates a market bubble, as illustrated below (Ilia D. Dichev 19).

Figure 11-1: Fair Value Feedback Loop



The feedback loop demonstrates the danger of overzealous application of fair-value reporting. For assets that are independent of a company's operations, this feedback loop does not apply. For assets that are tied to the internal operations of a company, this feedback loop could spiral in the opposite direction and have adverse effects on not only the company but also the entire market. This feedback loop interferes with the accurate portrayal of a company's performance on the income statement and therefore challenges my understanding of fair value valuation of assets.

B. Scenarios

The three career scenarios below: consulting, risk-analysis, and audit are presented to offer up context as to how consideration of the argument made against the current balance sheet model of financial reporting by Dichev in "On the Balance Sheet-Based Model of Financial Reporting" could impact a role different careers that interact with corporate reporting.

i. Consulting

Although I plan to enter the audit profession, if I were to one day make the move to consulting, this article would cause me to look beyond the income statement figures when analyzing the health of a company. I could divide the income statement and balance sheet figures into operating and financing activities to gain a new perspective into the health of the company. By understanding the critiques of the current model of reporting as presented in this article, I would be

better equipped to evaluate earnings in a consultant role to provide valuable insights.

i. Risk analysis

This article will elicit more cautious skepticism when approaching an audit engagement. I will be required to adhere to FASB standards when auditing a company, but I will be more skeptical of overzealous application of fair value reporting. The feedback loop as presented in figure 1 effectively conveys the dangers that fair value reporting conveys. Although the practice may be acceptable under GAAP, I would be more aware of the risks of fair value reporting for operating assets. This awareness could allow me to offer unique insights to the company regarding their fair value reporting and add value to the overall audit.

ii. Auditing

Although Columbia University's paper provides an argument against a balance sheet approach, the critique educated me on the balance sheet approach that will drive many current and future FASB standards. The added context surrounding FASB standards provided by this paper allows me to better understand the motivation of FASB behind standard-setting and better-equip me to apply the standards. If I am tasked with evaluating the GAAP-compliance of a company's earnings, I will more effectively do so if I understand how FASB believes that earnings should be reported under the balance sheet approach. By

understanding FASB's position that changes in net assets are the basis for evaluating earnings, I will better audit a company's financials.

Conclusion

This case study forced me to consider why certain accounting concepts are the way that they are. So much of what we learn in school we just take as fact but do not stop to consider why that fact exists. I easily forget when learning accounting principles that they are not laws of nature. Rather, accounting concepts and standards have been established over time by people. It is worth considering alternatives to certain accounting concepts, such as the balance sheet model of reporting, to understand why standard-writers created the standards the ways that they did.

Case Twelve

Earnings Announcements

3 May 2019

Introduction

This case study examines non-GAAP earnings as well as general press releases by corporations. The company used to facilitate this learning is Google. Google's non-GAAP earnings and their reconciliation to GAAP earnings are analyzed for appropriateness and enhanced information reporting. The correlation between earning announcements and stock prices is also analyzed. This case study elicits an increased understanding of non-GAAP reporting as well as the importance of effective corporate communication via press releases. Additionally, thorough analyzation of movements in stock prices and their causes creates an enhanced understanding of the stock market. This case demonstrates the ripples of a company as large as Google's financial reporting on the stock market and through the news. This ripple effect of financial reporting emphasizes the importance of accurate financial information, since inaccurately reported positive financial results can artificially inflate the stock market in cases only for the bottom to fall out and cost unknowing investors.

A. Analysis of Google's Press Release: "Google Announces Fourth Quarter and Fiscal Year 2013 Results"

i. How Google Arrived at non-GAAP Financial Measures as Mentioned in the Press Release

Google cites in its press release GAAP net income of $3.38 billion and non-GAAP earnings of $4.10 billion (Duncan 3). To arrive at non-GAAP net income, Google makes adjustments to GAAP net income to eliminate expenses related to stock-based compensation (SBC) and other

special items that are infrequent in nature, such as a restructuring charge, and to eliminate the net loss from discontinued operations net of tax . The company believes that these adjustments provide metrics regarding Google's core operations that are useful to both management and investors in decision-making.

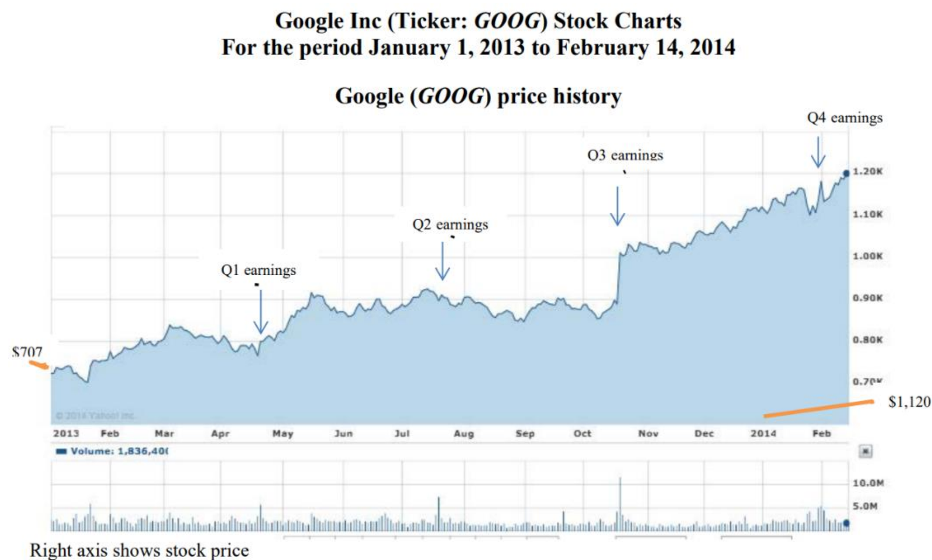
The removal of infrequent special items and the net loss from discontinued operations indeed provides a useful metric on the company's current and future income and cash flows, since the charges to GAAP net income are unlikely to persist on an annual basis. However, the elimination of SBC does not accurately portray future income and cash flows, since the charges will persist on an annual basis. Google does acknowledge this weakness in its non-GAAP net income. However, Google states that the rationale behind removing SBC is to eliminate expenses that are not indicative of its "recurring core business operating results" (Duncan 5). The argument that SBC is not indicative of Google's recurring core business operations is fair to an extent, but the SBC could be viewed as an ancillary investment in Google's human capital, which drives its operations. Since SBC is a recurring expense and it is incurred to drive its operations, it is a useful metric to consider. Google likely excludes SBC, because it is not a direct cost of its operations.

B. Stock Market Reaction to Google's 2013 Earnings Announcement on the Stock Market

i. Google Stock Price Movement in 2013 within the Context of 2013 Earnings Performance

Google reported fiscal earnings of $12.9 billion in 2013, up from $10.7 billion in 2012. Google's stock price movement over the course of 2013 reflects this improved performance by Google, as it grows from a little over $700 in January 2013 to $1,200 by February 2014 (Figure 12-1). There is a spike in Google's stock price that corresponds with Google's fourth quarter earnings from around $1,100 to $1,200. Along with the bottom line, Google's top line also grew over the course of 2013. This is a good signal to investors that Google is growing its sales and core business.

Figure 12-1: Google Stock Performance Jan. 2013 through Feb. 2014

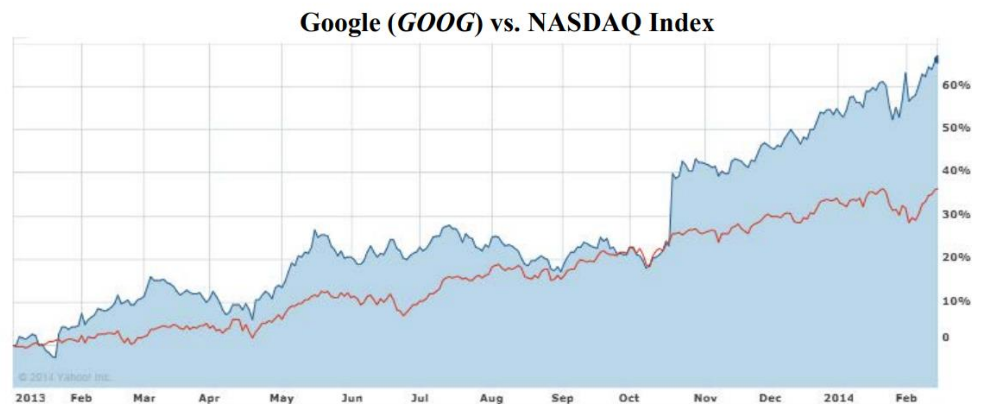


**The above graph and the markings on it were provided by the case study and is included in the thesis to provide a reference for analysis (Drake 14).*

ii. Comparing Google's 2013 Stock Price Performance to the NASDAQ index

Google's stock price rises at a much steeper rate than the broader set of firms trading on the NASDAQ exchange. Over the course of 2013, Google's share price grew by over twice the rate that NASDAQ grew (Figure 12-2). The market was therefore more confident in Google's future ability to sustainably grow its revenues and net income than it is for the average company.

Figure 12-2: Google Stock Performance Jan. 2013 through Feb. 2014 versus NASDAQ Index



**The above graph and the markings on it were provided by the case study and is included in the thesis to provide a reference for analysis (Drake 14).*

iii. Stock Market Reaction to Google's Press Release Announcing 2013 Earnings

The market perceived the earnings news in Google's press release as very good news. Before the press release and at the beginning of 2014, Google's share price was beginning to dip. However, after the press

release was made available at the end of January 2014, Google's stock price rebounded significantly in February 2014. This is due to Google's 2013 net income outperforming its 2012 net income and its 2013 fourth quarter income outperforming its 2012 fourth quarter net income.

C. Google's 2013 Earnings Announcement in the News

Whenever a company as large as Google reports their annual earnings, major business reporting publications such as the Wall Street Journal are quick to report on the earnings. This is because as demonstrated in Part B(i) on this case study, the announcements mightily impact the company's stock price. Significant moves in the stock of a large and influential company such as Google Inc. constitutes a newsworthy story. On the same day that Google released its earnings, Rolfe Winkler wrote an article in the Wall Street Journal breaking down Google's earnings.

i. Google's Fourth Quarter Revenue and Earnings Performance Against Consensus Analyst Forecasts

According to Winkler's article, Google's revenues exceeded consensus analyst forecasts by $1 million (Winkler). However, Google's non-GAAP EPS fell around $0.20 below consensus analyst projections. Regardless, Google's shares still rose by more than four percent after-hours. Since Google's non-GAAP performance compared to projections contradicts with the positive stock market reaction, investors likely put much less stock in Google's non-GAAP earnings

than its GAAP earnings. Google's GAAP performance compared to analyst projections does coincide with the positive stock market reaction.

ii. Reported Other Factors Contributing to Market's Reaction to Google's Earnings Press Release

Rolfe Winkler's WSJ article points to a 31 percent growth in advertisement clicks in 2013 as a major source of optimism for Google (Winkler). Additionally, revenues related Google's app sales on the Google Play store doubled in 2013. Google's sale of its failing Motorola division to Lenovo was well-received by the market. Google's increased investment in computing resources and human capital encourages investors that Google is focused on growth. Google's cash balance grew which indicates that Google is currently solvent.

Concerns noted by the article include an 11 percent dip in Google's revenue per click compared to 2012. The cause of this dip is the shift to mobile device advertisements which yield a lower return. The decreased margins on mobile advertisements is likely offset by the ad click growth that is provided by the increased accessibility of mobile advertisements. If the company continues to grow its ad-clicks, the decreased margins should not materially affect the company. Although net income increased from 2012, the article reports that its bottom-line results were disappointing (Winkler). Winkler's article demonstrates that perspectives on a companies' earnings can vary. Although the market reacted positively to the earnings announcement, some may see reason for concern or disappointment in the earnings figure. This demonstrates that although reading

articles on earnings announcements or watching stock movements is good for gaining perspectives on a company's earnings announcement, an astute investor would look at the earnings announcement and annual report themselves in order to form an original opinion on the earnings announcement, while taking various perspectives (such as market movement and media commentary) into account.

Conclusion

This case study illustrated the wide-reaching impact of financial reporting of publicly traded companies such as Google. The adherence to uniform accounting standards, such as GAAP, is a necessity for a fair and transparent market. This case demonstrated how a company can still legally manipulate its numbers to present favorable results via non-GAAP earnings in Part A. However, non-GAAP reporting is made possible only by clear disclosure of the non-GAAP nature of the manipulated figures, as well as an accurate reconciliation of the non-GAAP figures to GAAP.

The case also demonstrated the large impact that earnings announcements have on stock prices. In Figures 12-1 and 12-2, it was striking to me that looking at a graph of a stock's price over an entire year, you can visually see where the stock moved in response a company's released earnings. This fact emphasizes the need for sound adherence to accounting standards. People who bought Google stock as a result of its earnings would have unjustly suffered severe losses if Google's earnings later were discovered to be inaccurate.

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