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CASE STUDY SUMMARY: JOHNSON & JOHNSON AND MACY'S INC

by

Cameron Richardson

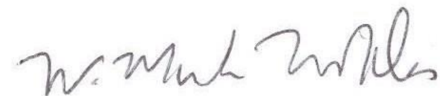
A thesis submitted to the faculty of The University of Mississippi in partial fulfillment of the requirements of the Sally McDonnell Barksdale Honors College.

Oxford, Mississippi

May 2023

Approved by

Advisor: Dr. Victoria Dickinson



Reader: Dean W. Mark Wilder

ABSTRACT

"JOHNSON & JOHNSON" and "MACY'S INC": An Accounting Analysis

(Under the direction of Dr. Victoria Dickinson)

This thesis, over a one-year period, covers conclusions derived from research on two different companies: Johnson & Johnson and Macy's Inc. Through a two-semester course taken within the scope of the honors college alongside Dr. Victoria Dickinson, I, alongside my respective group members for each company, were able to compile a thorough analysis of risks and business strategies the two corporations could identify and implement to manage present and future complications. This analysis followed standard conventions of the accounting profession, as our research was focused on identifying risks and strategies affiliated with audit, tax, and advisory services, modeling how professional life in accounting would be when attempting to grasp a full understanding of a certain company.

In addition, the research extended to contemporary issues as well, as my group members and I observed how current economic and political trends would impact each company. The rise of Environmental, Social, and Corporate Governance (ESG), inflation fears, COVID-19 impacts, and political turmoil domestically and internationally were all factors considered when researching the respective corporations. From this, we then put forth solutions for each company to improve their relative position. Whether it be to accelerate taxable income to avoid higher tax rates in the future or taking advantage of certain tax credits available to the company, our group compiled these findings over the scope of our research and presented them to accounting professionals for criticism and cross-analysis. Below you will find, in detail, the totality of our formal written research completed for my thesis. This first half of it includes the work for Johnson and Johnson, and the second half includes Macy's Inc.

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Honor Code

"On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this Honors College Senior Thesis."

Cameron Richardson

Johnson & Johnson

Will Bounds

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Johnson & Johnson

Company Overview

Week One

February 9, 2022

For week one, our group was tasked with researching our chosen company, Johnson & Johnson, a large pharmaceutical company that has made headlines since the advent of the Covid-19 pandemic. We were to provide a full company overview, detailing the base information we gathered as well as a list of the company's numerous subsidiaries and threats. Contained below is Johnson & Johnson's initial research overview; from this foundation, our group will expand our knowledge of the company throughout the semester leading up to our end of semester presentation.

Based in New Brunswick, New Jersey, Johnson & Johnson (NYSE ticker JNJ) has a net worth of around $450 billion dollars. At its core, JNJ provides products related to human health and well-being. With around 134,500 employees, the company engages in research and development as well as manufacture and sale for their three business segments: consumer health, pharmaceuticals, and medical devices. In 2021, the most recent calendar year, JNJ reported sales of approximately 93.8 billion dollars. When those sales are broken down among the three primary service lines, 15.5 percent, 55.5 percent, and 29 percent of total sales are split between the consumer health, pharmaceutical, and medical devices sectors respectively. These three key segments are broken down in the following paragraphs.

The consumer health segment is composed of baby and oral care, skin beauty, over-the-counter products, women's health, and wound care. As shown previously, the consumer health segment of JNJ generates the least amount of revenue. This observation is not an anomaly, as consumer health has generated the least amount of revenue each year for the last decade. What is perhaps most interesting about this business line is that JNJ is planning on splitting its consumer health division off from the pharmaceutical and medical devices sectors. JNJ claims that this move will help streamline and simplify its core processes while helping segments establish more

precise goals; however, while these benefits were certainly intended, another motivation could come from the negative press the consumer health segment has garnered. JNJ's consumer health segment is experiencing criticism and litigation for the safety risks of its talc-based baby powder, and, recently, the company has recalled some aerosol sunscreen products out of fear they contain a cancer-causing material. These negatives are also listed in the "threats" section as well. Separating this sector from the others might keep its worsening public image from poisoning other facets of the company.

The two larger revenue generating sectors are pharmaceuticals and medical devices. These divisions will remain a part of the parent company when JNJ completes its splitting off transition in late 2023. The subcategories included in pharmaceuticals are immunology, infectious diseases, neuroscience, oncology, pulmonary hypertension, and cardiovascular and metabolic diseases. Included in the medical devices business line of JNJ are prescription drugs, vaccines, and other new and developed technologies like robotics and artificial intelligence.

Of course, no analysis of JNJ can be complete without detailing its Covid-19 vaccine. The company created a one-dose Covid-19 vaccine released March of 2021, which now has proved to have an 85 percent efficiency rate in those 18 years or older.

1. News Articles

Looking through various current news articles, we learned that most of the news regarding J&J is linked to COVID-19 and their vaccines; however, their most popular products are still Band-Aids, Tylenol, and baby powder. A big headliner is how effective the J&J vaccine is and how it is going to continue to develop. Another topic in the news cycle is about the recent change to split the company into two companies. This division would separate pharmaceutical and medical devices from consumer health. The company has decided to do this to allow for

more growth and allocation to these areas. Johnson & Johnson stock increased after the announcement, likely because stockholders of the company will now own a share of each part of the company - essentially, they will own stocks in two publicly traded companies.

Recently, Johnson & Johnson has gotten a lot of attention from their Covid-19 vaccine. In February 2021, the United States Food and Drug Administration granted emergency authorization of J&J's vaccine. The company made the vaccine not-for-profit in efforts to combat the ongoing global pandemic. Their vaccine is said to be 67 percent effective in preventing moderate to severe Covid-19 cases 14 days after vaccination. Additionally, what makes the J&J vaccine different is that it only has one dose as opposed to others, which require two doses for full vaccination.

Johnson & Johnson have faced some controversy with their vaccine. A handful of cases arose of women across the country reporting cases of severe blood clots after receiving the J&J vaccine. One case of a 19-year-old, Emma, has just been able to walk recently after undergoing five surgeries and overcoming four strokes due to the J&J vaccine. The family is optimistic about the future, but disappointed that J&J have not reached out or given any type of financial support.

Despite various controversies, Johnson & Johnson is one of the most successful pharmaceutical companies. On the J&J website, they make sure to market their goals and missions. They have several articles that outline their equity and diversity agendas, how they want to improve their sustainability especially in healthcare, and the various awards that they have won for their research. The company has also promoted themselves and employees that have spots on various Fortune 500 lists. It makes sense that a company would only promote the triumphs instead of their problems, so it is good to keep this in mind when viewing the current events of JNJ and where the information is coming from.

2. Subsidiaries

Johnson & Johnson conducts business in virtually all countries of the world with the primary focus on products related to human health and well-being. As a result of the company's massive size and international influence, JNJ has over 250 subsidiary companies. And, given that JNJ classifies its business processes into the three operating sectors stated previously, we saw it best to distinguish the subsidiaries along these three segments above with the addition of a "miscellaneous" segment. The Miscellaneous segment includes investments, holdings, marketing, land management, sales, trading, audit standards, and asset management.

Consumer Health	**Pharmaceutical**	**Medical Devices**	**Miscellaneous**
Beijing Dabao Cosmetics Co., Ltd., China	Cilag, Switzerland	Berna Biotech Korea Co., Korea	Apsis, France
Ethicon, Europe/US	Ethnor Farmaceutica, Venezuela	Biosense Webster Ltd., Israel	Berna Rhein B.V., Netherlands
GMED Healthcare BVBA, Belgium	Janssen, Europe/US	Cordis, Europe/US	EES Holdings, Mexico
J-C Health Care Ltd., Israel	McNeil, Europe/US	Crucell, Europe/US	FMS, Switzerland
Vania Expansion, France	OMJ Pharmaceuticals, Europe/US	DePuy, Europe/US	High Wycombe Property Management Limited, United Kingdom
Neutrogena Corporation, Delaware	Omrix Biopharmaceuticals, Israel/US	Lifescan, Europe/US	J.C. General Services CVBA, Belgium

Wellness & Prevention, Inc., Michigan	Ortho-Clinical Diagnostics, Inc., Europe/US/Japan	Medos, Switzerland	JHC Nederland B.V., Netherlands
	Tasmanian Alkaloid Pty. Ltd., Australia	Mentor Worldwide LLC, Netherlands/US	JJC Acquisition Company B.V., Worldwide
	Tibotec-Virco Comm. VA, Belgium	OBTECH Medical Sarl, Switzerland	J&J Investment Ltd., Worldwide
	Xian-Janssen Pharmaceutical Ltd., China	Acclarent, Inc., Delaware	J&J Consumer Holdings, Worldwide
	ALZA Corporation, Delaware/California	Animas Corporation, Delaware	J&J Financial Services, Worldwide
	Centocor Biologies, LLC, Pennsylvania	Codman & Shurtleff, Inc., New Jersey	Latham International Investment Company, Ireland
	Crescendo Pharmaceuticals Corporation, Delaware	Cougar Biotechnology, Inc., Delaware	Turnbuckle Investment Company, Ireland
	JOM Pharmaceutical Services, Inc., Delaware	Diabetes Diagnostics, Inc., Delaware	CNA Development LLC, Delaware
	Noramco, Inc., Georgia	Micrus Endovascular LLC, Delaware	ISO Holding Corp., Delaware
	Patriot Pharmaceuticals, LLC, Pennsylvania	Nitinol Development Corporation, California	J&J Holdings Inc., Nevada
	Scios Inc., Delaware	SterilMed, Inc., Minnesota	JNJ International Investment LLC, Delaware

		SurgRX, Inc., Delaware	Micro Typing Systems, Inc., Florida
		Therakos, Inc., Florida	Middlesex Assurance Company Limited, Vermont
		Therapeutic Discovery Corporation, Delaware	Refresh Holding, In., Delaware
		Veridex, LLC, Delaware	Rutan Realty LLC, New Jersey

3. Potential Threats:

After looking at Johnson & Johnson's annual reports, subsidiaries, and external articles we were able to pinpoint several threats to the company. One of these threats is lawsuits. At first glance, it might seem that most of the lawsuits are coming from COVID-19 related vaccines and other medical procedures, but there have been many lawsuits regarding the consumer health segment of the company.

Johnson & Johnson has faced many lawsuits with their talc products with over 20,000 filed suits. The claimants believe the talc baby powder caused cancer, and the talc-based powder has been discontinued in North America. Recently, the company settled in a lawsuit to pay Native American tribes for opioid problems. This settlement will get critical resources to tribal communities to help with the opioid addiction crisis.

A huge threat to every big company is competition. One of Johnson & Johnson's biggest threats has been the pharmaceutical company Pfizer. The two companies have been competitors

long before the pandemic as they both hold large market shares in the health industry. Since the pandemic, the competition has only increased. The Johnson & Johnson vaccine has around 85 percent efficiency, while Pfizer has around 95 percent efficiency. Additionally, the Pfizer vaccine is FDA approved for those 16 years or older while Johnson & Johnson is FDA authorized through Emergency Use Authorization for those 18 years or older, but it is not approved yet. The Johnson & Johnson vaccine was released later than the Pfizer vaccine, and it went through much more backlash after a few cases of blood clotting side effects were reported, so the vaccine was recalled. Also, Pfizer is in the lead on the international front with the vaccine; the Pfizer vaccine has been distributed to 165 countries while the Johnson & Johnson vaccine has made it to 106 countries.

Along with lawsuits and competition, there are government regulations, which are a threat to the company's revenues. There is a ceiling on how much pharmaceutical companies can charge for their products. Also, countries across the globe price drugs very differently. As an international company, staying compliant is a constant challenge. Additionally, surgery deferrals have been a recent threat to the company. Surgery deferrals fall under the segment of medical devices within J&J. Over the last several years, this category has decreased in sales. From 2019 to 2020, there was a 11.6 percent decrease as reported in the Johnson & Johnson 2020 annual report. They are attributing a decrease in this category because of COVID-19. While there has been a decrease, it is still the second largest profitable segment within the company.

The company is also a victim of corporate espionage. Johnson & Johnson has been ranked #1 on the pharmaceutical industry list for nine years in a row. For their pharmaceuticals, they invest heavily in research and development. This intellectual property has become more and

more vulnerable for corporate espionage and some hackers linked to North Korea were recently discovered trying to steal information on the vaccine.

JNJ constantly pursues the research and development of new products to fit the changing needs of consumer healthcare. New products released in the last five years accounted for 25 percent of its 2020 sales. Patent expiration and corporate competition only increase these needs. The company also has some charges that can be costly for the future. Johnson & Johnson recently halted the development of the drug Bermekimab, which was being tested for a skin disease treatment. In 2019, the company struck a $750 million deal to purchase all rights from XBiotech Inc for this drug, which was already in Phase 2 development, but the company announced this month that it had to record a non-cash impairment charge of $610 million.

Overall, we learned a lot about Johnson & Johnson. Going into this assignment, we knew the basics about the company and some of the news regarding COVID-19, but as we dived deeper, there was much more information we had no idea of. One of the biggest things we learned was about the future of the company and how the consumer health segment is going to diverge from the other two segments. Additionally, taking a closer look at the financials and projections of the company gave us insight into what topics we want to focus on in the coming weeks.

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Johnson & Johnson

Audit Phase

Week Two

For this week's case study, we were assigned to audit Johnson & Johnson (J&J). Our audit of the company began with us looking up J&J's recent 10-K and other financial statements to assess each account. The goal of this was to take a closer look at each individual account and figure out the materiality to better determine the risks associated with it not being properly audited. We then proceeded to pick three of J&J's potential riskiest accounts. With these accounts we further summarized the risks associated, looked at the internal controls for that specific process, found the best tests of transactions to audit, and recommended how to use data analytics to better audit the account in the future. Johnson & Johnson is clearly a well-established company and makes sure to follow SEC guidelines when it comes to their auditing process. Having us investigate the auditing process gives us a better understanding of what to focus on to help ensure that the current and future shareholders are informed as best as they can be.

To investigate the riskiness of each account we studied the existence, completeness, and valuation of each account as well as the internal control structure and data analytics to improve the auditing process. Each of these components are important to look at because they will show how a company could misinform people when looking at their financial statements. Existence shows that whatever is being stated in the financial statements is correct. Without the true existence of the account, it can skew things such as the current ratio, debt ratio, turnover ratio, etc. Completeness verifies that each item that should be included in the period is accounted for. This makes sure that account amounts are in the correct period and with the correct number. Valuation is a common procedure to determine the correct value of the asset, liability, or owner’s equity account. If accounts are not valued correctly, it can again misinterpret the information being given to shareholders. One way to verify these accounts is to check the internal controls of a company. Johnson & Johnson has many internal controls to try and prevent risk. With the

increase in technology, data analytics can be used to speed up and create a more accurate process of auditing. Overall, auditing gives us the opportunity to explore and share knowledge with current and potential shareholders so that everyone can benefit from the performance of Johnson & Johnson.

Johnson & Johnson's inventory could be at risk for existence, completeness, and valuation. Regarding existence, Johnson & Johnson could mistakenly not include inventory on consignment on their balance sheet. An example of this could be their vaccines that the company is producing and sending out to various pharmacies around the nation. If Johnson & Johnson fail to include this inventory on their balance sheet, then their inventory would be grossly misstated. Another problem that could arise with inventory is that the sale of inventory might not always be recognized in the correct period. This would cause a problem with completeness. Lastly, valuation should not be a large problem for Johnson & Johnson's inventories. They are currently stated at a lower of cost or net realizable value determined by the FIFO method. If Johnson & Johnson remain consistent with that basis of evaluation, their balance sheet should show an accurate representation of their inventory. Some critical auditing controls for inventories that could be put in place would be documentation and reconciliation of accounts. Those two internal controls would ensure that inventory on consignment would be included in Johnson & Johnson's inventory and that the sale of that inventory would be recognized in the correct period. Several substantive testing measures could be put in place to ensure that these mistakes would be caught. Flow documentation would ensure that goods on consignment would be included in Johnson & Johnson's inventory. Cut-off tests would make sure that all sales of inventories would be included in the correct period. Data analytics and automatic robot processing would play a huge role in making sure that problems associated with inventory do not occur. Johnson & Johnson

could implement an automated system that assigns all sales of inventory to a period whenever said sales occur. In terms of not including goods on consignment in inventory, that would be more of a human error that a computer program may or may not pick up on.

As the largest asset or liability account on J&J's most recent balance sheet, J&J's intangible assets account must be monitored closely. Given the nature of the pharmaceutical industry, it is no surprise the intangible assets account is so large. J&J consistently faces challenges regarding the development and defense of their patents, as competitors try to undermine J&J's intellectual property rights. The company even admits this issue as one of its major risk factors. It is also a bigger challenge for the company to acknowledge the expiration of its patents, which could lead to future revenue and market losses as similar products or technologies are used by competitors. Due to these factors, intangible asset values may be subject to large year-by-year fluctuation. Additionally, J&J includes a multitude of items as intangible assets. From evaluating each of its existing patents to monitoring the value of the company's purchased in-process research and development, mistakes can lead to the account's inflation. These mistakes can be related to an intangible asset's existence, completeness, and valuation, further testifying to the account's complexity.

There can also be disputes with patents that end up in courts due to copyright claims by one party over the other. As can be seen Advanced Medical Optics, which was acquired by J&J in 2017 sued Alcon, claiming it violated multiple patents on laser eye surgery technology and then filed an amended complaint that Alcon had stolen copyrighted computer code. Johnson & Johnson have filed many such lawsuits against Alcon and court proceedings are currently underway in the United States, Germany, and United Kingdom. There was progress made in Germany, where the Hamburg Regional Court upheld a suit brought by Alcon which means that

Johnson & Johnson subsidiary AMO will not be able to sell some of its ophthalmic surgery products in Germany and this is the first decision in many court proceedings looking at patents for laser technology.

The largest discrepancy between the two most recent balance sheet statements from the intangible assets section came from "purchased in-process research and development." J&J acquired six billion dollars' worth of in-process R&D from Momenta Pharmaceuticals, accounting for most of the increase. J&J's intangible assets are analyzed once annually in the 4th fiscal quarter. From this, one could identify a loophole in which a company's intangible assets are acquired after the annual intangible asset evaluation date, leading to these new assets not being properly accounted for. Of course, this oversight could lead to incompletion and improper values embedded in the largest asset section of the balance sheet. With regards to internal controls, perhaps J&J can request that the company they are acquiring audit their intangible assets pre-acquisition, eliminating the risk they gain inflated asset amounts. Also, given the massive size of the intangible assets section in the balance sheet, higher-up accountants with more detailed knowledge of the company are probably the proper workers to authorize the value amounts given to these assets.

Another account that could be risky for Johnson & Johnson is their accounts payable. Completeness is the most relevant assertion in the audit of accounts payable. Understating the accounts payable balance would distort the balance sheet and make Johnson & Johnson look more profitable than it is to please shareholders. Because the company's inventory account could be misstated, the inventory purchased on credit would then cause their accounts payable to be understated. An obligation to pay controls would be useful for J&J to verify the accuracy of purchase invoices. These controls might include purchase order approvals and invoice approvals.

Other internal controls useful for accounts payable are data entry controls and payment entry controls. Data entry controls require invoices to be recorded before and after approval to verify all invoices are recorded and no duplicates are recorded. Payment entry controls are a crucial step in ensuring accounts payable are not understated. These controls include segregation of duties, tracking check numbers, and securing check storage. To make sure the account is not misstated, the auditor can perform substantive tests like confirmation of balances with outside parties and physical verification of inventory purchased on credit. J&J can also take a sample of payable accounts and reconcile them to supplier's statements. They can also compare supplier statements with year-end accounts payable balances to ensure completeness. Performing cut off tests is another substantive testing application to confirm that transaction dates and payments match. Data analytics allows auditors to extract and visualize a wide range of financial information as well as non-financial information. Data analytic techniques like pulling supplier data, inventory reports, shipment arrival records, and purchase records would efficiently and effectively help auditors test the balance of accounts payable of Johnson & Johnson. Auditors need to verify that the accounts payable for Johnson & Johnson are correct and not understated to correctly present the profitability of the company.

After reviewing Johnson & Johnson from an auditing standpoint, our group was able to learn much more about the company. After looking closer at Johnson & Johnson's balance sheet and income statement as well as their 10-K, we were able to identify possible scenarios that would leave the company vulnerable to risk. We agreed on what we thought were three of the potentially most risky accounts and were able to dive into how each account could be manipulated to misinform shareholders. Our group also learned more about the concepts of existence, completeness, and valuation as well as internal controls and substantive testing. This

case opened our eyes to what a real auditing experience is like and gave us brief insight into rigorous auditing procedures. This information will allow us to do better in our future internships along with providing an in-depth and accurate report of Johnson & Johnson during the case study presentation.

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Johnson & Johnson

Tax Phase

Week Three

Due 2/16/2022

For the third week of our company's case study investigation, we were assigned to investigate different tax strategies that our company could employ. We were given various accounting firm websites regarding current tax planning topics as a starting off point. After thoroughly going through those websites and doing our own research of tax strategies that could positively impact Johnson & Johnson's tax planning, we found two tax strategies that would help lower expected corporate tax rates. The purpose of this week's assignment was to find the importance of tax planning strategies because it helps the finances of the company and allows them to hopefully keep as much money as possible in their own records. With a company as large as Johnson & Johnson, tax planning is important because there are lots of corporate taxes that need to be paid. And with a large income, a large portion of that could go to taxes that they are mandated to pay. Diving into these tax strategies and justifying why Johnson & Johnson would benefit from using them gave us a better understanding of tax planning in general and how to implement it.

As a preface to our proposed tax strategies, we must analyze Johnson & Johnson in both its current and future form. One of Johnson & Johnson's three business lines, consumer health, is set to split away within the next two years. Of course, this decision possesses tax ramifications that we will have to interpret from the lens of the two remaining business lines, pharmaceuticals and medical devices.

"Reverse" planning results with an acceleration of income in order to plan for future years tax rates to increase. Johnson & Johnson would benefit from this tax strategy because the corporate tax rate right now is 21 percent, and it will most likely increase to 26.5 percent after the proposed increase under the House Ways and Means tax plan. Reporting more income now would cause income to be taxed at a lower rate than if reported in later years. The "reverse"

planning strategy would include Johnson & Johnson implementing "reverse" tax accounting method changes, which aims to expedite income and defer deductions. The company would also need to accelerate taxable gain as soon as possible in order to profit the most from the gain. This type of planning would allow for the company to decrease its deferred tax liability. Johnson & Johnson can elect out of bonus depreciation in order to take advantage of "reverse" planning. Electing out of bonus depreciation will increase their taxable income and defer the depreciation deduction on fixed assets into future years when the tax rate is higher. This consideration would not require a Form 3115 to be filed. However, other considerations like cost segregation studies, electing out of the accelerated prepaid deduction, and recognition of loan fees would require a Form 3115 to be filled out. This form reports a change in accounting methods to the IRS. Reverse planning would be a short-term tax strategy because once the corporate income tax rate is increased to 26.5 percent in a few years, the accounting methods would need to change back to the traditional tax accounting method, deferring income and accelerating deductions.

With the consumer health segment of Johnson & Johnson leaving soon, our group thought it would be best to analyze specific tax strategies most attractive to the remaining two segments, pharmaceuticals and medical devices. In recent financial statements, the consumer health segment's R&D expenditure is lower than the other two business lines; furthermore, consumer health's R&D expenditures make up a smaller portion of relative sales for the segment than the pharmaceuticals and medical devices segments respectively. Simply put, R&D is not as important for consumer health as it is for pharmaceuticals and medical devices. As a result, as consumer health departs from Johnson & Johnson's main operating business, R&D operations will have a larger impact on the corporation's balance sheet. Johnson & Johnson spends billions of dollars annually on R&D at increasing rates in Europe and the United States, and this growth

does not appear to be slowing down. To illustrate, J&J is considering filing for 14 new drugs by 2025. R&D tax planning for a company is so vital because the United States and many other countries around the world offer tax credits to companies based on their R&D account status. To stay relevant, Johnson & Johnson must maximize the tax benefits coming from R&D.

To be specific, the R&D tax credit can give you a roughly 14 to 20 cent tax credit for every qualified dollar spent on R&D, depending on the circumstance. This proportion might be small, but the importance of R&D at Johnson & Johnson necessitates intentional tax planning to maximize the achievable benefits from American law. A first step to maximize the credit will be identifying what can be considered expenditures for R&D. Almost all research expenses in an activity qualifying as R&D can be considered a qualifying expense, as well as wages paid to employees related to the activity and the cost of supplies and computing related to the research. Johnson & Johnson should initially maximize their R&D listed expenses through these qualifying expenditures. Next, Johnson & Johnson should analyze the locations in which their research operations are being conducted. 36 American states possess certain tax credits for qualifying R&D expenditures. Johnson & Johnson should be prudent in recognizing which states offer the best tax benefits with respect to R&D and utilize that information when deciding where they should conduct their research. Of course, with nearly half of their revenue coming from international sources, Johnson & Johnson certainly conducts research in many other countries. Johnson & Johnson should be aware of each country's specific tax credit environment relating to R&D, as the United States does not include R&D expenditures outside the country as applicable expenses for a tax credit from the United States government. Johnson & Johnson risks paying substantially higher taxes than necessary if the company does not properly pay attention to these regulations.

To help conceptualize this strategy in rudimentary numerical terms, Johnson & Johnson's R&D expense increased by roughly 11.1 percent year-by-year between 2019 and 2021, with 2021's expense at a staggering $14.714 billion. If this number continues to increase at this rate, the projected expense for the next three years would be $16.347, $18.162, and $20.178 billion respectively. Of course, some of this projected R&D expense entails R&D related to the soon-departing consumer health segment; however, the consumer health segment only makes up roughly five percent of the annual R&D expense, so this segment's departure will have minimal impact on future R&D expenditure amounts. Even if only half of those expenses are qualifying expenses under American law, Johnson & Johnson stands to receive a substantial 14 to 20 percent tax credit if they are prudent in classifying their expenses.

So, to project across the three future years above, the R&D tax credit would be 20 percent of those projected values, or $3.270, $3.632, and $ 4.036 billion respectively. Keep in mind these numbers could very well be less than expected in the later years as the consumer health segment leaves the main company. Furthermore, even if half of the R&D expense does not qualify for the credit due to locational or situational factors related to the R&D department, the credit would remain in the billions of dollars category. Johnson & Johnson has a huge incentive to be responsible for its tax planning with its R&D.

For further emphasis, the notion of a tax credit itself is enough to draw special attention to the classification of R&D expenditures. Unlike a deduction, which reduces your taxable income for a given period, a credit is a dollar-for-dollar subtraction from taxes due, meaning tax credits wield significantly higher tax benefits than deductions. The R&D tax credit has the potential to be the strongest tool a research-oriented company like Johnson & Johnson has in minimizing the taxes they have to pay in both the short and long term.

When we were first introduced to this week's case study it was a bit overwhelming. None of us knew too much regarding tax strategies, especially tax strategies for such a large and successful company. Through our research with the links provided to us and additional research, we learned about a handful of tax strategies and how to apply them. We decided to go with “reverse” planning and R&D tax credits as our two strategies to apply to Johnson & Johnson. It was interesting to discover how much a tax strategy can impact a company’s financials. We continued to learn more about Johnson & Johnson as well as the ins and outs of their financials. This information will help us perform better in our future internships and while presenting our case in front of the panel.

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Johnson & Johnson

Advisory Phase

Week Four

Due 3/23/22

For this week's assigned case study, we were tasked with advising our company, Johnson & Johnson (J&J). As part of our advising of J&J, we are assigned to figure out which strategy they pursue, use Excel to make charts that display various accounts and their amounts (revenue, assets, operating income, etc.), reevaluate their two biggest threats, and finally compute the company's return on assets, profit margin, and asset turnover for future years. Each of these aspects allowed us to take a further look at J&J and see trends and patterns in their company. For the strategy aspect, we are aware that J&J is a massive company with three different business segments, so it was challenging to decide on one specific strategy, therefore, we opted for a mixed strategy. It was also interesting to look at the company's figures and see the trends in the past and how those could be projected into the future. Contained below are our findings, research, and recommendations for J&J.

1. Strategy

J&J uses a mixed strategy of cost leadership and product differentiation with their three business segments: consumer health, pharmaceuticals, and medical devices. The consumer health segment concentrates on cost leadership by having the competitive advantage of lower costs of products in the consumer health industry, while the pharmaceuticals and medical devices segments use more of a product differentiation strategy by having products that are unique from others in their industry. For example, the J&J COVID-19 vaccine was a one dose vaccine which differentiated the pharmaceutical from others in the market at the time. The consumer health segment, which has the lowest revenue of the three segments, is separating from pharmaceuticals and medical devices in the next few years. Johnson & Johnson's product differentiation strategy includes research and development (R&D) especially in Europe where there are more research and development credits available than the United States and then produce new products and

better technologies like they are planning on making 14 drugs and they plan on making and they plan on becoming a 60 million a year drug maker by 2025.

2. Excel Values

When comparing some of the financial data from the past five years, there were a couple of trends that we noticed. We tracked data from financial statements from the year 2015 to the year 2020. During that time, J&J's revenue and cost of goods sold (COGS) steadily increased. The reason behind this trend is because J&J had grown exponentially over the past five years, especially with the introduction of their COVID-19 vaccine. Johnson &Johnson's selling, general, and administrative expenses (SG&A) have remained rather constant over the past five years. Johnson &Johnson's operating income has steadily decreased over the past five years. A reason for this could be the increasing cost of research and development. Johnson &Johnson's assets and liabilities have both grown over the past years. However, their liabilities have grown much quicker than their assets having a 79 percent increase to asset's 31 percent increase. Johnson &Johnson's return on assets, profit margin, and asset turnover has consistently gone down from 2015 to 2020. This data supports our claim of J&J pursuing product differentiation because of the large expenses that have been incurred to ensure unique products. The cost of goods sold as well as research and development expenses have increased while operating income has been decreasing.

(in millions)	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Revenue	70074	71890	76450	81581	82059	82584
COGS	21536	21685	25354	27091	27556	28427
Selling, General and Administrative Expense	21203	19945	21420	22540	22178	22084
Operating Income	19748	20529	18607	19004	17646	16698
Assets	133411	141208	157303	152954	157728	174894
Liabilites	62261	70790	97143	93202	98257	111616
Return on Assets	15%	15%	12%	12%	11%	10%
Dupont Decomposition:						
Profit Margin	28%	29%	24%	23%	22%	20%
Asset Turnover	53%	51%	49%	53%	52%	47%

3. Threats

One of J&J's largest threats is litigation liabilities. A large pharmaceutical company like J&J is constantly under the risk of being held liable if a medication is deemed to be toxic or ineffective. Most litigation the company faces runs through their consumer health segment. Fortunately, that segment of the company is planning on leaving J&J's main corporate operations within the next 18 to 24 months, forming their own company. To minimize legal expenses and liabilities from future events, J&J can expedite consumer health's exodus from the company.

Of course, a potential fear of this plan is that it would be too quick of a transition; J&J might be negatively impacted by a rushed exit. However, the consumer health segment makes up the smallest portion of revenue among the three main business lines, as well as accounting for a tiny fraction of the company's R&D expenditures. Consumer health, while important, is not an all-encompassing feature of the company; J&J should be able to speed up its exit without harsh ramifications.

To tackle this project, the barriers to consumer health's departure must first be understood. Employee representative bodies, J&J's Board of Directors (BOD) approval, and regulatory and governmental requirements stand in the way of the exit. To solve this, J&J can make it clear within the company the benefits of the split for their employees, prioritizing the resolution of any reservations employees may have. By being proactive on this front, J&J can avoid making later concessions in negotiations with employee bodies, as employees would also be in favor of the split. For the BOD, J&J should make clear to them the hefty litigation risks the company faces if consumer health fails to leave the company's main operations. For each day consumer health remains an integral part of J&J's main operations, the company faces increased financial and reputational risks. Helping the BOD understand the importance of this measure

would expedite consumer health's departure, and possibly create new initiatives spurring the business line's exit. The final roadblock would be possible regulatory restrictions preventing consumer health from leaving quickly. The only way to bypass this barrier is to be consistently transparent with the IRS and other regulatory bodies. Full transparency and punctuality will only aid the exit of consumer health.

It would be expected that in the short term, J&J's expenses would increase. In-company marketing to employees about the move as well as prioritizing the exit by way of management and regulatory standards will undoubtedly incur costs, reducing short-term operating income. Additionally, since an entire segment of the company is departing, it is expected to see a proportional decrease in assets, SG&A, COGS, and revenues. However, we find that in the long-term, J&J will become a more stable company, as the liability threat inherent in consumer health will no longer be tied to the main company's operations. This should result in much lower expenses and liabilities in later years, more than making up for the increased expenditures initiating the exit.

Another threat that J&J faces as the largest pharmaceutical company in the world is corporate espionage. Especially with their pharmaceutical and medical device segments, the company invests heavily in research and development, creating vast amounts of intellectual property that can be stolen by hackers or employees inside the company. A way to lessen this threat could be to conduct more thorough employee background checks, implement more employee monitoring software, and put into place more internal controls to prevent the intellectual property of the company from being stolen. Choosing to execute these protections would increase expenses in the next few years because of the price of costly software and labor hours in general to take the time to implement the protections. While revenues would most likely

not change, the added expenses would lead to a decrease in operating income. COGS, SG&A, assets, and liabilities would probably not change over the next few years, but if the company does not take these protective measures, assets could decrease with the loss of intellectual property. This intellectual property, if lost, could in turn also decrease revenue if protective measures are not put in place.

4. ROA, Profit Margin, and Asset Turnover

After implementing our plans to reduce the amount of damage that these potential threats may face, we can predict how J&J's financial statements would look in the coming years. When consumer health leaves, we find that return on assets and profit margin would likely decrease in the short term, as the expected loss from the exit would be ranging from $500 million to $1 billion dollars. This estimate would likely be even higher if the company was to speed up the transition away from consumer health.

However, in later years, return on assets and profit margin would undoubtedly increase, even from the numbers seen in years prior to the initiative to remove consumer health. This is due to the nature of the consumer health business line relative to the other two lines, pharmaceuticals and medical devices. Consumer health sells many customer-oriented over-the-counter products while the other segments rely on product differentiation and higher cost services and medications. With consumer health leaving, we can expect asset turnover to naturally decrease as basic products like baby powder and band-aids are no longer offered by the company. This would give rise to a more specialized product style, yielding higher return on assets and profit margins between the two business lines that already create the most revenue. As a result, we find it plausible that return on asset and profit margin values initially stay stagnant in

the next one to two years, but eventually increase to around 13 and 25 percent respectively, with asset turnover dipping to 45 percent in later years.

We believe that if J&J takes the proper steps to prevent corporate espionage, then their return on assets, profit margin, and asset turnover will stay on their current track and will not deviate.

Conclusion

Overall, our group discovered many insights on our company. We determined that J&J currently pursues a combination of product differentiation and cost leadership strategies between the three business lines. We also compared various accounts from financial statements from over the past five years. We looked at assets, liabilities, cost of goods sold, operating income, SG&A, and revenues. We also re-evaluated what we thought to be J&J's two largest threats. We decided that their two largest threats were litigation risk from their consumer health sector and corporate espionage, as J&J is the largest pharmaceutical company in the world. We tried to create action plans for J&J to implement to help prevent these problems from arising. We used these action plans to recompute J&J's return on assets, profit margin, and asset turnover. During the process of completing this case study our group has gotten a small sense of what it is like to professionally advise a major publicly traded client.

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Risk Phase

Week Five

Due 3/30/22

For this week's case study, the goal was to assess our company, Johnson & Johnson's (J&J), biggest risks. We investigated J&J's greatest operational, macroeconomic, and cybersecurity risks. After figuring out which was the greatest risk in each category, we had to find the source of them and what actions we could take to mitigate those risks. With a large and international pharmaceutical company such as J&J, there are many risks that could jeopardize the company so narrowing it down to one per category was an initial challenge. The purpose of this week's case was to see the potential and largest risks in hopes of learning how to better control and prevent them.

Perhaps the largest risk a pharmaceutical company like J&J faces is the constant defense and development of intellectual property. In order to stay competitive in the industry, J&J must be able to acquire, develop, and defend patents and other property in order to create and sell products. The impact of patent expirations would result in revenue and market share losses. These losses are also expected to have a stronger influence in the coming years, as consumer health is expected to depart from the main operations of the company. The other divisions, pharmaceuticals and medical devices, are much more dependent on R&D expenses and patent protection, while consumer health is focused on less specialized over-the-counter products like Band-Aids. It is reasonable to expect the research-oriented side of J&J to become more important as the general consumer-oriented division, consumer health, leaves the company.

J&J will be facing a wave of patent expirations in the next five years. Drugs such as Stelara and Rilpivirine will lose their patent for the drug in 2023 and Rilpivirine, Remicade, and Tremfya will in 2024 to 2028. The Remicade drug later lost its patent because it was found "unpatentable under the doctrine of obviousness-type double patenting" by the United States Court of Appeals for the Federal Circuit. Simply put, J&J's struggle to manage and develop

patents is an indefinite one. In order to continue as a pharmaceutical hegemon and prevent competitors from copying their products, they must devote time and resources to the defense of their intellectual property.

A seemingly simple way to achieve this goal is through the hiring process. J&J must continuously recruit top-tier intellectual talent to preserve their status in the pharmaceutical industry. Of course, hiring excellent personnel is easier said than done. The pharmaceutical hiring market is competitive, and J&J must be able to manage and motivate its employees effectively. To complete this task, J&J can listen to the ethical and social concerns of its employees while ensuring moral integrity in the workplace. By satisfying employee demands related to environmental, social, governance (ESG) issues, J&J can enhance their reputation and attract high-end talent.

Another threat the company faces is the ongoing risks of operating internationally. Nearly half of J&J's revenue comes from international sources, so the company faces revenue and reputational losses from their actions abroad if they are not careful. As a result of operating internationally, J&J remains compliant with numerous different laws and economic structures relative to the company they operate in. To stay up to date, J&J undoubtedly incurs many expenses to avoid major losses, as well as making strides to ensure their products are allowed in every country that they operate in. As an example, J&J's Covid vaccine has fought to establish itself in the European Union (EU). In November of 2021, the EU rejected 60 million doses of the vaccine due to contamination fears, resulting in the supply being discarded. Avoiding a loss such as this with all products marketed internationally would require strict vigilance on J&J's front, undoubtedly incurring costs.

Another risk inherent in operating internationally is the reputational impact of the countries they operate in. J&J faces the dilemma of working to satisfy the demands of the country they operate in while simultaneously preventing other countries and populations from being angry in marketing to those countries. This concept is not a foreign one, as large organizations in film and athletics have been criticized recently for concessions made to other countries in pursuit of profit, seemingly undeterred by possible human rights violations in those countries.

With reference to J&J, the company recently cut their sale of personal care products in Russia amid concerns of the ongoing war in Ukraine. In this type of situation, J&J must be careful to manage their reputation while preventing their company's operations from being compromised. If the company fails to find the "sweet spot" on that spectrum, J&J stands to lose their integrity, financial stability, or both. A way to manage this risk is by staying up to date with current events and consistently applying ethical judgment. By staying consistent and transparent with their values, J&J can avoid major losses, even if "the right thing" results in short-term dips in income.

J&J is a global company with over 125,000 employees. The company is in over 60 countries with around 250 subsidiaries. This vast number of operations leads the company to incur supply chain risks with the recent supply chain crisis of backlogs across major supply chain hubs and international ports. The pandemic caused a shortage in workers which led to a large reduction in production capacity globally. The supply chain crisis has yet to be solved partly because of the "bullwhip" effect where companies order a surplus of items than the demand anticipates which leads to over-ordering. To avoid the "bullwhip" effect of the supply chain crisis, J&J needs to make sure they present accurate information regarding retail demand. This

accuracy will prevent overcorrection for these supply chain disruptions while still allowing the company to meet their changes in demand. As stated previously, the company announced that it will be suspending its sale of personal care products in Russia and that it would stop doing clinical trials in Russia. This could have a further impact on the supply chain because J&J is one of the top pharmaceutical companies and it will be impacted by this. It will most likely lead to other companies entering its market and more revenue losses which are already complicated due to supply chain changes.

A corporation as large as J&J faces many cybersecurity risks every day. In fact, they experience around 15.5 billion cybersecurity incidents each day. Most of these incidents are minor and are not cause for concern. However, in J&J's eyes it only takes one major incident to occur for the company to lose money and customers. J&J has four ways that they are approaching the fight against cybersecurity. These four tactics are "baking security into the DNA of every product, having strict oversight of the entire security process, listening to researchers, and working to educate regulators." J&J has started to make sure that the solutions they develop have security built in. They also have consolidated their cybersecurity and research and development (R&D) teams into a single group to work more efficiently. J&J has also taken more of a strict, hands-on approach to their own security. This has led them to scrutinize more over third-party vendors and service providers. They have also started to complete security assessments on every aspect of their manufacturing and distribution. J&J's security team regularly attends cybersecurity conferences with the goal of learning more about attack techniques and their own vulnerabilities. Lastly, J&J works closely with cybersecurity regulators to create common best practices. As a group we have identified a cybersecurity threat that we believe J&J may be at risk for. We believe that J&J could be hacked by a major anonymous

organization that would cripple their manufacturing and distribution capabilities. This organization or organizations may hold J&J's network hostage and would not give control back to them unless a ransom was paid. This happens to smaller companies more around the world, but a large organization is also at risk. J&J's tactics they already have in place are great for preventing such attacks, but we believe that they should be investing more. If J&J's systems were to be crippled for even a couple of days, that would equate to millions of dollars of lost revenue. One way that we believe that J&J should protect themselves is to invest in more training for their employees. Employees are often the source of secret information for hackers whether they are aware of it or not. Training employees on how to be fluent with cybersecurity threats would decrease J&J's liability significantly.

After determining the greatest operational, macroeconomic, and cybersecurity risks for J&J it helped us better understand the internal and external controls of the company and how to prevent the risks in general. We learned how many possible risks there can be for such a huge company. The initial narrowing down of the greatest risks was our first challenge and then finding the sources of those risks and how we think those risks could be mitigated was an insightful process. It gave us a new perspective on how to think like a J&J to solve these issues. We discovered the major risks in each of the three categories listed above and which ones have the most impact on the company. Through our research we feel like we got a better understanding of the types of risks J&J must deal with and how they mitigate those risks. This was a great learning experience and case study to be able to add to our case exhibition coming up. It allows us to have a better understanding of J&J as a whole and how they could go about dealing with these risks.

Macy's Inc

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Operational Risk Assessment

Macy’s Inc.

Overview

For this week, our group was first tasked with gaining an understanding of our company's structure. From this structure, we needed to observe a multitude of factors. Geographic location, number of stores, number of brands and subsidiaries, specific products sold by these brands, and target demographics were all important variables our group needed to understand to accurately paint a picture of Macy's Inc. (stock ticker M).

In addition, we were also tasked with evaluating a variety of risk factors most relevant to the company and its industry. Our group vetted the threats of inflation, interest rates, energy prices, supply chain disruptions, political considerations, and global unrest to discover what challenges each respective threat presents to Macy's Inc. After researching these risks, we then tackled what could be the greatest threat to the company's future.

Aside from gaining a stronger understanding of Macy's Inc., our group developed multiple new skills throughout the past week that will help us move forward. Organizationally, we gained experience writing concisely concerning a prompt in the face of massive information. It is easy to write extensively about large macroeconomic events in the world like inflation and the supply chain crisis (among others), but it is difficult to identify and evaluate only key pieces most relevant to Macy's Inc. As the semester progresses, we expect to only become more adept at keeping our writing direct. In addition, we also developed and improved our research abilities, drawing from the corporation's annual report and outside sources to uncover how specific risks could affect Macy's Inc. And, although sounding simple, our group communication skills improved. This assignment was our group's first attempt at collaborating in and out of class to

complete a task. As we approach our case competition and final presentation, we must improve this skill further to maximize the quality of our work.

<u>Macy's Inc. Organizational Structure</u>

Macy's Inc. (the Company) is a merchandising company that sells men's, women's, and kid's apparel and accessories as well as cosmetics, home furnishings, and other consumer goods (SEC). The Company has operations in Macy's, Macy's Backstage, Market by Macy's, Bloomingdale's, Bloomies, Bloomingdale's The Outlet, and bluemercury. The Company has 725 locations and operates in 47 states in addition to the District of Columbia, Guam, and Puerto Rico. Bloomingdale's also operates in the United Arab Emirates, Dubai, and Al Zahra, Kuwait. Most stores are in heavily populated urban and suburban areas in the United States.

According to the SEC, The Company has four major subsidiaries. The first is a bank subsidiary, FDS Bank, that supports the issuance of credit card accounts to customers and

provides customer service and credit marketing for those credit cards as a part of the credit programs through The Company. The second subsidiary is Macy's Systems and Technology, Inc which provides electronic data processing and management information services. The third subsidiary is Macy's Merchandising Group which provides design and development services for Macy's private label brands. The fourth subsidiary is Macy's Logistics and Operations, which is responsible for warehousing and distribution.

Macy's Inc. Risk Factors

The first key risk our group analyzed was inflation. To no surprise, inflationary pressures have squeezed consumer spending habits, leading to consumer caution in retail markets. In particular, the Macy's store's profitability has been limited as the middle-income segment, typically the target demographic for Macy's, has lessened its spending. At the end of the most recent fiscal quarter for Macy's in 2022, consumer sales dipped by 2.9 percent. This decrease in spending creates a bulk of problems for the store, since fewer sales result in inventory surpluses, yielding more issues for retailers. However, the Macy's store is only one brand of Macy's Inc. The other two major brands, Bloomingdale's and bluemercury, have not seen a decrease in sales in the most recent quarter. Instead, these luxury-focused brands have seen upticks in sales of 8.8 and 7.6 percent respectively. Macy's Inc. CEO Jeff Gennette has referenced how high-income customers have not limited their spending even in the face of inflation, providing evidence as to how Bloomingdale's and bluemercury have churned out strong quarter two numbers. Without change in how Macey's Inc. approaches their customers in a period of rising costs, executives can only hope high-income customers remain undeterred in the face of inflation while the bulk of their consumer base regains their footing.

Directly tied to inflation, interest rate changes have affected the macroeconomic landscape, resulting in changes in the retail sphere. Simply put, as costs rise, interest rates rise in an effort to disincentivize spending and curb inflation. The opposite side of this was shown during the peak of the pandemic, as interest rates dropped to incentivize spending in order to stimulate the economy, which consequently played a part in the financial dilemmas ahead of the world market now. To contextualize this issue in the retail market, low interest rates lead to consumers having more disposable income to spend at retailers like Macy's. Unfortunately, rising interest rates apply the inverse effect. Customers are losing money, as higher interest rates result in the price of borrowing money increasing. In addition, the higher cost of borrowing money impacts borrowing money for businesses as well. Companies struggle to obtain favorable rates when looking to borrow money to cover expenses in periods of higher interest rates. Since lending money is an essential element of the business world, Macy's Inc. will have to adapt to higher rates by either finding other ways to pay off expenses or making intelligent borrowing decisions.

The soaring energy prices that began to rise in late 2021 are being felt by companies all over the world. While Macy's Inc may not be at a direct risk from the high energy prices, their supply chain is. The shipping industry is one of the most energy-intensive sectors according to ING Research. This could potentially hurt Macy's Inc shipping and distribution channels for both in store and online shopping as shipping costs could be larger. According to Macy's Inc Sustainability Report, Macy's Inc has already begun to look at alternatives for energy due to climate change. Macy's is striving to have 10% less energy consumption by 2025. Macy's Inc also has Energy Management to track energy efficiency and potential renewable energy

opportunities across the company. While energy prices may be rising, Macy's Inc is looking for ways to minimize its energy consumption.

The global supply chain disruption has affected a lot of businesses, Macy's Inc included. The clogged ports, trucker shortages, and empty shelves are severely hurting the retail industry and their bottom line. Macy's Inc is at a risk because of their omnichannel model they are selling a lot of different products from different places. Issues with the supply chain hurt Macy's Inc. when they cannot meet customer demand quickly enough. These shoppers begin to shop online rather than in-store. While the supply chain has been an issue, Macy's Inc is looking to combat it by investing $548m in an automated fulfillment center in North Carolina, according to Just Style News. This new center will account for around 30% of Macy's Inc.'s digital supply chain and will help strengthen the omnichannel model. This will help with the ever-growing customer demand quickly and efficiently.

Given how Macy's Inc. is almost entirely based in the United States, any risks concerning the political climate will be centered around US political occurrences. It is no surprise consumers today make purchasing decisions depending on the political stances of companies. Americans are 44 percent more likely or 53 percent less likely to purchase from a retailer they agree with or disagree with, respectively. And, unfortunately, attempting to appeal to both sides does not help you escape this conundrum. Years ago, Macy's went under fire from both sides of the political aisle concerning the Trump family. In 2015, the store dropped Trump brand merchandise after the then-candidate stated allegedly derogatory comments, resulting in conservative Americans being frustrated with the retailer. Years later, after the retailer was reluctant to drop Ivanka Trump's merchandise, citizens on the left began to migrate toward stores that aligned with their views who dropped her clothing. To appeal to both sides, Macy's still alienated many. In the

future, Macy's Inc. must continue to carefully survey the increasingly polarized American political landscape. From this, they will need to find defensible moral stances that both minimize public frustration and represent shareholder viewpoints.

Global unrest is another risk factor that can have a negative impact on Macy's Inc. soon. The conflict between Russia, Ukraine, and NATO has already indirectly created some economic threats, being that Russia is one of the leading producers of oil and natural gas. Though as previously stated, the vast majority of Macy's Inc, operations are in the United States, and the US in general does not receive many imports from Russia. However, energy markets are global which means energy prices around the world are all related. This might not be a direct risk to Macy's Inc., but it is a great threat to their supply chain and can cause the prices of raw materials and finished goods to continue to rise. This kind of global unrest inherently leads to Americans cutting back their spending on normal and luxury goods which could prove to be detrimental to department stores such as Macy's and their luxury counterparts of Bloomingdale and bluemercury.

Macy's Inc.'s Most Severe Threat

Macy's Inc.'s largest threat is the ever-increasing e-commerce presence in the everyday lives of today's consumers. According to Macy's Inc.'s 10K filing from March 25, 2022, their consumers are continuing to migrate towards online shopping, which has offset a lot of their efforts contributing to their brick-and-mortar stores. Many of the risks that we previously presented culminate in Macy's Inc.'s biggest threat being eCommerce. While Macy's Inc. is one of the largest and oldest retailers in the nation, there are many competitors that infringe upon

their clientele. Part of Macy's Inc.'s appeal and one of its biggest strengths is its in-store shopping experience, which is becoming more and more obsolete as society continues to change after COVID-19. As one of the largest and most notable retailers in the United States, Macy's specifically has struggled with the decreasing opportunities to present this strength. This increase in online shoppers is drawing consumers away from brick-and-mortar stores and onto their laptops, which could result in closure and restructuring, which would negatively contribute to operations and cash flows. In their 10K statement, Macy's Inc. stated that they are opening new segments, Market by Macy's and Bloomie's, to bring consumers back to their physical locations.

Macy's Inc. currently has plans to increase its eCommerce presence by decreasing delivery expenses, growth margin expansion, and has other initiatives in place to increase digital sales. To go along with their initiatives to increase their online shopping presence, Macy's Inc. has made investments to help fulfill online demand and elevated delivery speed expectations. While eCommerce may be Macy's Inc.'s biggest threat, its investments, effort, and contributions to bettering its online presence look promising in aiding its future growth and success.

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Audit Risk and Planning

Macy's Inc.

Overview

For this week, our group was tasked with analyzing Macy's Inc. from an audit risk perspective. After reviewing Macy's Inc.'s annual report and supplementary financial statements, we identified ways in which various accounts along the balance sheet may be open to misstatement. Further, we examined the materiality of possible misstatements and how the ramifications of a misstatement on a particular account may affect the rest of the financial statement. In addition, we also suggested a few internal controls for each identified item that we believe would best mitigate the associated risks that may lead to an account resulting in an inaccurate valuation. Much of this paper will be speculative, as the most recent annual report for Macy's Inc. listed an unqualified opinion over both the financial statements and internal control procedures, which is the highest-level opinion an audit firm can give a company. Nevertheless, we still believe it is important to develop some possibilities for how accounts related to a large retailer could fall into misstatement due to error or fraud.

Our group learned multiple new skills over the past week that will help us move forward. First, this assignment helped us better understand the basic protocols and processes behind conducting an audit. The team brainstormed ways accounts may be misvalued before entering an audit engagement and identified controls, which are integral steps firms take when approaching clients. It was very valuable learning a little bit about what auditors look for when auditing and getting to learn some of the audit procedures. A final skill we learned was ways data analytics can be used both internally and externally via the audit firms and companies themselves to make sure all the information being reported is accurate and complete.

Merchandise Inventories

The first account that may be risky for Macy's Inc. is Merchandise Inventories. As a merchandising company, most of Macy's Inc.'s value comes from its inventory. Because of this, inventory could potentially be misstated or misvalued. Inventory must be properly recorded and valued because it impacts financial statements like the balance sheet, income statement, and statement of retained earnings. About the numbers given in Macy's Inc. 10k, Inventory accounts for roughly 65% of current assets (Macy's 10k). Because inventory is such a significant share of current assets, it must be calculated correctly. The value of inventory on the balance sheet determines the amount of profit or loss the business generates. According to Melanie Chan with Unleashed Software, when there is a discrepancy in inventory (the value of inventory captured in records differs from the value of actual inventory held) there will be variations in the cost of goods sold which directly impacts the income statement via gross profit (Chan).

Internal controls for the inventory account need to cover a multitude of tasks. The controls need to protect the assets against theft, ensure compliance with policies and laws, and ensure accurate and reliable data reporting. One critical internal control for Merchandise Inventories is physical control or a physical inventory count. According to Lumen Learning, "Physical inventory counts are a way of ensuring that a company's inventory management system is accurate and as a check to make sure goods are not being lost or stolen" (Lumen Learning). A physical inventory count is done at the end of the period to make sure inventory levels are accurately reported on the balance sheet.

Another internal control used for inventory is adequate documents and records. Macy's Inc. should maintain complete and accurate accounting records. For this to happen there should be competent and honest employees hired. In addition, there should be at least one or more business documents to support the accounting transactions that occur involving inventory. Lumen Learning says, "these source documents are an integral part of the internal control structure" (Lumen Learning). Furthermore, these source documents should be serially numbered. Not only should these documents exist, but they should also be checked from time to time to ensure validity. These two internal controls are critical for the inventory account.

On the other side, auditors must come in and run tests to make sure the inventory is not misstated. Since Macy's Inc. has a massive inventory account, its auditors have to run many inventory audit procedures to make sure that the valuation given is correct. The first test they can run is an analysis of the cutoff. According to Steven Bragg with Accounting Tools, "auditors will examine your procedures for halting any further receiving into the warehouse or shipments from it at the time of the physical inventory count, so that extraneous inventory items are excluded" (Bragg). Auditors will test the last couple of shipping transactions before the physical count and the transactions after to make sure the inventory is properly accounted for. Another audit procedure is to observe the physical inventory count. Auditors will discuss the counting procedures with the company and test count some inventory. This is to verify all count tags were accounted for. If the company does not use a physical inventory count, it might use cycle counts. The procedures for this are like that for a physical count. Auditors will reconcile the inventory count to the general ledger by tracing the valuation from the physical inventory to the count in the general ledger to make sure the balances are the same. These auditing procedures are the

substantive tests run on the inventory account; however, there are many more tests run in addition to these to ensure the correct valuation was given on the balance sheet.

Data analytics has become increasingly important for audit firms because it reduces risk in audits and adds value to their clients. Data analytics improves audit quality. According to ACCA Global, "It allows auditors to more effectively audit the large amounts of data held and processed in IT systems in larger clients" (ACCA Global). With Macy's Inc. and its large inventory account, this is very helpful. One way data analytics can be used to perform audit tests in the inventory account is by matching purchase orders to invoices and payments. Another is by comparing the last time an inventory item was purchased with when it was sold and at what price. Finally, data analytics can be used for the segregation of duties testing. This would show all the users involved in processing the transactions and the data attached to those transactions. Overall, using data analytics is very beneficial to provide a proper audit of a company.

Property and Equipment

Property and equipment are Macy's Inc.'s biggest assets according to their balance sheet, meaning that it is the most material asset. The property and equipment account includes all the brick-and-mortar stores, as well as all the technology and machinery that is equally as important to efficiency and operations. Macy's Inc. operates out of 725 stores in 43 countries and owns or leases over 112 million square feet. The materiality of this account and its percentage of total assets, 32 percent, means that misstating this account could lead to large mistakes concerning all other aspects of the financial statements, much like inventory.

There are multiple risks to misstating the Property and Equipment account that could have adverse chain reactions. For example, if a store location was missing, that could mean that every piece of inventory, every labor cost, and every single cost associated with that particular brick and mortar location was also missed. In the "Guidance Note on Audit for Property, Plant and Equipment" published by KPMG, it states that inherent risk is one of the main risks to consider, including fraud risk (KPMG Knowledge Update). There need to be tests to ensure the completeness, cutoff of transactions, determine client rights, establish proper valuation and/or allocation, and the accuracy of transactions, correctness and appropriateness of classification, depreciation and carrying value, all concerning property, plant, and equipment (KPMG Knowledge Update). The misstatement of the property, plant and equipment account is an avoidable risk that could be very costly to Macy's Inc.

Another risk factor that should be considered is fraud risk. Common fraud risks to look for were listed by KPMG as purchase price from a related party, incorrect write-offs, repairs and expenditures debited to the property, plant and equipment account, capitalism of an expenditure, incorrect record of a purchase of an asset when the asset has not been received by the company, record of an asset that benefits an individual rather than the company (KPMG Knowledge Update). Any of these risks could be detrimental to the entirety of the company's operations, depending on the severity of the issue and at what organizational level the risk is found.

One internal control that would be beneficial to implement would be to keep track of separate ledgers. Separate ledgers would help ensure that all costs relating to property, plant, and equipment are properly accounted for and reduce the risk of error (Garcia). This seems like a very elementary concept, but even the simplest of practices still help to go behind to check for and correct any errors. For Macy's Inc., this could be having a team of accountants keeping their

own ledgers and then comparing to ensure accuracy or seeing where a mistake has been made. A test that an auditor could use to check the accuracy of the ledgers would review the ledgers as normal. These tests could also be done by a computer system, which would help with efficiency and maximization of time for employees and auditors.

An additional internal control that could prevent misstatement of the property, plant, and equipment account would be to implement purchase authorization (Garcia). This implementation of checks and balances would help to ensure that all purchases of property, plant, and equipment are being made in the best interest of the company rather than an individual or other party. This could eliminate potential issues of abuse of company assets for personal benefit, purchases made at an inflated price with a related party, and other fraud risks. For Macy's Inc., this could mean that purchases for a store location would need to be approved by a regional manager or another party higher in the organizational chart than the store itself. An audit test to account for this could be to check purchases are not being used for personal use and to investigate purchases and their terms to ensure that purchases were made in the best interest of the company rather than individual. These tests would be most beneficial if done by a team of auditors, rather than an automated process, as this could be considered a more subjective risk that could be up to interpretation of the auditor/auditing team.

Leases

Perhaps in prior years, lease liabilities for companies would have been perceived as risky due to the adoption and implementation of a new leasing standard in 2019. However, the new standard has been in effect long enough for public companies to adapt. Nevertheless, there are still concerns about the account that must be addressed. As the largest liability account on the

balance sheet aside from long term debt, Long-Term Lease Liabilities possesses both the size and the complexity to be open to misstatement. There are two audit assertions that we believe may be vulnerable to the account: completeness and valuation.

Relative to completeness, the vast size and makeup of the lease liabilities and related right of use asset accounts may lead to an inaccurate collection of lease liabilities. When companies record leases, they must record leased assets related to all various departments owned by the company (CoStar). In the case of Macy's Inc., leases related to all three of its main brands, Bloomingdale's, Bluemercury, and Macy's store, must be correctly counted for an accurate balance. This process can be difficult and time-consuming. One benefit for Macy's Inc. is the nature of their leases, as many of them are related to real estate comprising stores and office space (seekingalpha). Real estate leases tend to be easier and less complex than non-real estate leases like equipment. But, for a company radically adapting to the new online shopping environment, managing leases related to their ongoing physical stores may prove difficult.

More pressingly, lease liabilities for Macy's Inc. may have risks affiliated with the valuation assertion. Inherently within leases, many estimates are used to predict the leases' present value, including the rate of borrowing and the exercise of options related to the lease (CoStar). Most relevant to Macy's Inc. is the exercise of lease options. Much of the balance of lease liabilities in the account is related to projected payments related to lease extension options that Macy's Inc. expects to exercise. If Macy's Inc. does not extend an option they expected to extend or vice versa, the account may be over or understated. As a result, Macy's Inc. must continuously assess the status of its leased real estate to ensure the company is not misstating that liability and related asset.

Of course, there are some internal controls that can mitigate these risks. To ensure proper valuation of the account, the control of proper authorization can be used. Essentially, experienced company personnel should be making the decisions regarding how leases and their related exercise options should be used, as these decisions require an upper-echelon holistic view of company operations. If a lower-level employee is left to estimate the value of complicated real-estate leases extending multiple periods, the account may succumb to misstatement. In addition, to combat completeness risks, Macy's Inc. may implement and maintain adequate documentation and record-keeping procedures. This way, the likelihood of this account missing important transactions related to leases will decrease.

Auditors can test this account and these related assertion risks in multiple ways, both qualitative and quantitative. Qualitatively, auditors may ask relevant questions to proper employees of Macy's Inc., ensuring the correct level employees oversee the transactions taking place. By asking multiple employees regarding which people oversee which valuation assertions to lease in the financial statements, the risk of improper employees overseeing the account will decrease. On the quantitative more computing side, auditors can check and sample the records of transactions within Macy's Inc.'s information systems. This way, auditors can verify the completeness of recordkeeping related to leases from the source documents to the financial statement account balance.

Data analytics and information technology can improve each of these auditor tests as well. Macy's Inc. undoubtedly uses information systems to record transactions, and employees would certainly have system ID's unique to them. In their testing of proper authorization, auditors may be able to check digitally which employees are handling the estimates of lease fair values. Of course, auditors must first determine how trustworthy the internal company system is.

In addition, the manual process of testing transactions for completeness would certainly be extremely tiresome and costly. Auditors can use technology and automation to test these accounts to identify missing links and inconsistencies quickly. With these automated procedures in place, the odds of auditors identifying possible flaws that slipped through Macy' Inc.'s internal controls increase tremendously.

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ESG Cybersecurity Risk Assessment

Macy’s Inc.

Overview

This week, our group was tasked with evaluating Macy's Inc from both an Environmental, Social, & Governance (ESG) and Cybersecurity perspective, identifying ways Macy's Inc handles these sectors. In addition, with respect to ESG, we analyzed how ESG would impact the accounting world in general. The opportunities and challenges presented within ESG will only increase as this field becomes more complex and regulated. This phenomenon is especially true since investors, one of the primary beneficiaries of public accounting work, are likely to view ESG with a higher regard in future years. From this template, our essay is structured to first discuss ESG within the wide scope of public accounting, then narrow down our ESG scope to Macy's Inc itself and its industry. From here, we move into the latter part of our paper, observing how cybersecurity risks affect Macy's Inc and its industry ecosystem.

As a product of our work this week, one apparent skill we improved upon is our ability to understand our profession and all its moving parts. It is difficult to imagine ESG or any derivative of it becoming irrelevant in the next decade. As future public accounting professionals, this assignment gave us an understanding of a highly trending topic in the business world. We believe this experience could grant us the ability to speak with professionals in a less superficial, more dynamic way. Also, we now know how to look at cybersecurity as a real risk for any company as most companies have experienced a cybersecurity failure at least once. We now have a more holistic view of a cybersecurity threat as a threat to a company's reputation and business partners, not just its bottom-line financial information.

Environmental, Social, & Governance (ESG)

ESG has become increasingly more relevant in the business world, and specifically the accounting industry. According to the Corporate Finance Institute, "ESG is best characterized as a framework that helps stakeholders understand how an organization is managing risks and opportunities related to environmental, social, and governance criteria" (Corporate Finance Institute).

The Accounting Profession

How exactly does ESG apply to public accounting? The public accounting industry can help pioneer the regulation of ESG accounting by helping establish the standards of measurement. According to the Harvard Business Review article titled "The Future of ESG is…Accounting?" which was published on December 3rd, 2020, the International Financial Reporting Standards Foundation (IFRs) asked for the creation of regulations with the idea that it would marry financial performance and sustainability performance. As one would expect, having a defined standard helps take all subjectivity and guesswork out of ESG accounting, which is beneficial for everyone. Nevertheless, ESG is still a very divided topic within the public accounting profession. Depending on a client, fellow employee, or user's opinion of ESG, financial accounting firms are taking a risk by presenting their firm's stance on the topic. Another risk that could arise would be liability risk, as firms may help establish ESG standards, but may not follow them.

Challenges in Measuring ESG

One of the difficulties and prolongment of establishing ESG standards is the question of how to effectively measure ESG. There have been multiple nonprofit organizations who have

attempted to aid in the establishment of these standards, but there are a vast number of factors that play into ESG. This large number of factors have made the development process more difficult, as there appears to be no clear answer on who is responsible for the development and compilation of said standards and regulations. There has been some progress made, as of November 3, 2021, the IFRs developed the International Sustainability Standards Board (ISSB). As stated by IFRs, “The intention is for the ISSB to deliver a comprehensive global baseline of sustainability-related disclosure standards that provide investors and other capital market participants with information about companies’ sustainability-related risks and opportunities to help them make informed decisions” (IFRs.org).

The World Economic Forum provided our group with an interesting article by Punit Renjen, Global Chief Executive Officer for Deloitte. This article posed some interesting questions and thought-provoking statements. Renjen stated that he is aware of the other side on this issue that “argue(s) that business is overstepping its bounds by trying to deliver more to society than just profit” (Renjen). It appears that the World Economic Forum is in favor of the establishment of ESG guidelines and that the way to implement these is to work from top- global businesses-down. Large companies such as Blackrock have integrated ESG into their operations, stating:

> “Our approach to ESG integration focuses on identifying financially material sustainability insights – those that we believe may impact the financial performance of clients’ portfolios - and including those insights into the broader mix of traditional financial information used to manage those portfolios” (ESG Integration at BlackRock.)

If there are large companies and organizations who are willing to put themselves in the pioneer group that is establishing ESG guidelines, we will begin to see it trickle down into all aspects of business and the world.

Macy's Inc and the Retail Industry

Similar to a lot of corporations, Macy's Inc has recently taken major steps in regard to sustainability and the rise of ESG. In the first quarter of 2022, Macy's Inc announced the launch of its own social purpose platform called "Mission Every One". To go along with this platform, Macy's Inc has committed to directing $5 billion by 2025 to their people, partners, products, and programs with the goal of creating "a more equitable and sustainable future" (Macy's Inc). This new enterprise-wide social economic platform is focused on three pillars of impact: people, communities, and planet. Each of these pillars contains their own set of goals, commitments, and initiatives, but they are all focused on empowering others and creating unity. More specifically, its focus on people includes increasing its investments in underrepresented designers, brands and business partners, products and services service providers. The platform focuses on its corporate grant funding towards advancing human rights, racial justice, workforce development, and economic opportunity. It also accelerates the diverse representation of its leadership (30 percent ethnically diverse representation by 2025), supports more diverse-owned businesses, creates a fully funded educational benefit program for its colleagues (35 million investment over the next four years), and raises its minimum pay rate to $15 per hour. Its focus on community includes donating $100 million to nonprofit organizations that support the emotional well-being and education of underrepresented youth, providing funding to support programs and scholarships for youth in fashion ($2 million by 2025), and offering mentorship and employment opportunities. Its focus on Planet includes making sustainable style accessible, incorporating sustainably

sourced raw materials and fibers into the design of its own products, and investing ways to eliminate waste by reducing, reusing, and repurposing materials (Macy's Inc).

The launch of "Mission Every One" is a step in the right direction for Macy's Inc in relation to ESG. If Macy's Inc can follow through with the commitments it has made and continue to build off of them, then the company will be in a good position as the importance of ESG grows. However, Macy's Inc is not currently in great standing as far as its ESG ratings. According to Yahoo Finance, they are in the 15th percentile for ESG Risk Rating, MarketScreener has Macy's ESG Refinitiv rating as a B, and MarketBeat has given Macy's Inc a +0.9 percent for its M Impact Ratio. Greenhouse gas (GHG) emissions, waste, and scarce human capital are the biggest negative factors on Macy's Inc's sustainability, with GHG emissions creating the largest negative impact (MarketBeat).

While this may not be a good position, Macy's Inc is aware of its carbon emissions, and they recognize this issue multiple times throughout its Sustainability Report. Its GHG Emissions greatly decreased from 2016 (over 800K metric ton CO_2e) to 2021 (less than 500K metric ton CO_2e), and Macy's Inc plans to continue this trend. Macy Inc has currently set several Sustainable Stewardship Goals that the company wants to achieve by 2025 which include reducing energy consumption by 10 percent and increasing in-store recycling rate to 80 percent (Macy's Inc). Several risks remain for Macy's Inc. The risk of shifting energy prices can have a direct impact on the cost of operations, and climate-related issues and Macy's Inc's energy production and consumption can lead to reputational risk. These risks are monitored closely as part of Macy's Inc's Enterprise Risk Management process and through membership groups such as the Sustainable Apparel Coalition (Macy's Inc).

As we have already stated, ESG has become and is becoming increasingly more important in the business world. Current ESG regulations are already affecting companies' financial reporting, the way they are viewed in society, and most importantly, their ability to raise capital. As ESG regulations become more prevalent, so will companies' commitment and focus to it. Macy's Inc and other retail brands are no exception to this (Steinhaeuser).

Currently, it is not clearly stated but it appears as if ESG issues are moving from a primarily voluntary disclosure-oriented dimension to a regulatory one. This will lead to corporations creating or hiring risk and compliance teams to oversee specific ESG activities. A recent example of this is the SEC requiring mandatory reporting of Scope 1 and Scope 2 GHG emissions (Steinhaeuser). The Scope 1 and Scope GHG emissions are already in Macy's Inc's last Sustainability Report, but more of these ESG regulations will require more efforts in collecting, verifying, and acting upon data. As far as they are viewed by society, it is extremely important that a retail brand like Macy's Inc is looked upon favorably and can keep a good reputation. As more ESG data is disclosed to the public and investors, it is crucial that Macy's Inc is viewed as a community driven and sustainable company. In today's climate, all of these affect a company's ability to raise capital, as well as their relationship with their customers and suppliers. ESG score has become one of the main viewing points of investors. Anders Liu-Lindberg said, "ESG is a crucial consideration for fundraising efforts because it focuses the mind on the viability or necessity of the business itself" (Liu-Lindberg).

Macy's Inc understands the importance of ESG and is acting. Jeff Gennette, Chairman and Chief Executive Officer of Macy's said, "We are transforming our business from a position of legacy to one of leadership" regarding launching "Mission Every One" (Segal). Whether Macy's Inc intentions are completely pure or not, the company knows how important the public

view of a retail business is and would rather get out in front of the ESG movement then be left behind.

Cybersecurity Risks

The Retail Industry

The retail industry is a very attractive industry for cybersecurity attackers. According to Threat Wave, 24 percent of cyberattacks targeted the retail industry which is more than any other industry (Threat Wave). Retailers collect and store a wide variety of customer information from PII to credit cards. This makes them highly attractive for data attackers and thieves. Most retailers, Macy's Inc included, are a mixture of brick-and-mortar stores and e-commerce. This means retailers have complex technology systems to oversee everything. With a growing number of retail transactions being online-some $861 billion according to Threat Wave-the retail industry is becoming more and more susceptible to cybersecurity failures (Threat Wave).

Macy's Inc has done well in terms of minimal data breaches in the last 10 years, unlike other major retailers like Target and Neiman Marcus Group. In July of 2018 there was a breach in Macy's Inc's online payment systems. This breach was like the ones affecting retail companies all across the industry. However, Macy's Inc suffered another data breach in October of 2019, just the following year. Caleb Townsend with US Cybersecurity Magazine said, "The website was hacked by implementing malicious scripts, with the intent of stealing customer's payment information" (Townsend). This breach only affected a small number of customers and Macy's Inc has not experienced another data breach like this since then.

There is a variety in the types of cyber criminals and their motivations. According to Norwich University, "Cyber criminals, also known as hackers, often use computer systems to

gain access to business trade secrets and personal information for malicious and exploitative purposes' (Norwich University). Common types of cyber criminals are identity thieves, internet stalkers, phishing scammers, and cyber terrorists. Specifically in the retail industry, people who are likely to commit cybersecurity breaches are those trying to obtain credit/debit card information to steal money or personal information to sell on the dark web. According to Cybercrime statistics, in 2019 72 percent of cybersecurity breaches were financially motivated (Lazic). Overall, the retail industry, and Macy's Inc specifically, are high targets for cybersecurity breaches.

Macy's Inc

For a retail company like Macy's Inc, perhaps the most important asset hackers attempt to gain access to is information concerning their consumer base. Credit card data, personal information (such as a Social Security number), and healthcare information are most sought after (Macy's Inc 10-k). And, as a retailer, Macy's Inc's risk of cyberattacks spikes toward the end of the calendar year. Predictably, much of Macy's Inc's revenue comes from the holiday season, as shopping frequency increases at that time of the year. Macy's Inc's annual report even lists this holiday trend as a risk factor for a multitude of reasons, some of which are an overreliance on fourth quarter revenues and increased operating costs for those periods. Surprisingly, Macy's Inc does not list cybersecurity as a part of the seasonal revenue concerns within this risk factor subsection of the report, even though there was a recent cyberattack on company operations in the holiday period as stated previously.

On October 15th, 2019, Macy's Inc reported a breach in their system that occurred on October 7th (Greig, Jonathan). The breach was committed through "card skimming JavaScript" being placed into sensitive areas of Macy's Inc's system, like the "Checkout" and "My Wallet"

pages. From here, the hackers were able to obtain credit card information, addresses, and names for an entire week before being spotted. This revelation heavily impacted both Macy's Inc's financials and reputation. Immediately when the public became aware of the hack, Macy's Inc's stock price dropped 11 percent, highlighting investor and consumer worry over Macy's Inc's cybersecurity controls. Cyberattacks such as this one affect customers the most, as it is primarily consumer data being leaked and sold on the dark web.

Furthermore, what makes cybersecurity such a difficult issue is that, in some cases, the threat is out of the central company's hands. Third-party businesses who routinely interact with Macy's Inc could fall victim to an attack, leaving Macy's Inc exposed. This threat is outlined in the annual report, showing how numerous cybersecurity safeguards, like encryption, firewalls, and antivirus software could be undermined in the case of a third party or contractor is breached. Of course, business interruption or loss resulting from third party failures makes cybersecurity an ever-present issue for companies.

Are the Measures Adequate?

The pandemic made online transactions considerably more important to a company's operating procedure. Although there are possible advantages in efficiency and transaction records that come with online sales, cybersecurity concerns have become much more prevalent. Employees working remotely and continuous interactions with third parties have only exacerbated these risks. Fortunately, Macy's Inc has lined out detailed steps to mitigate risk, including raising employee awareness and working with partner businesses to maximize system security, alongside other policies.

However, throughout our research, we could not find specific policies from Macy’s Inc to address the increased risk during the holiday period, even though those months present the ideal time for hackers to initiate attacks (Brownfield, Andy). Perhaps Macy’s Inc already does this and does not release specifics, but one should expect a retailer with an obvious seasonal revenue cycle like Macy’s Inc to increase cybersecurity investment during the holiday season. An attack like the one they suffered in 2019 was a general method specifically altered to attack Macy’s Inc. As online operations grow and criminal hacking activities grow alongside, one would expect Macy’s Inc to maximize authentication procedures and antivirus or anti-malware software during its busiest season. The costs would likely rise, but if increased measures prevent a situation like the 2019 October hack, the company will save capital and maintain both its reputation and consumer base.

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Tax Planning

Macy's Inc.

Overview

This week, our group found appropriate tax planning recommendations for Macy's Inc. (stock ticker M). To do this, we first researched and identified plausible tax credits or options Macy's could employ to mitigate their tax liability. At this stage in the process, we had to navigate around many moving parts, including probable political results that may affect future tax policy and adjusting tax recommendations to fit the future direction of Macy's business model. Upon uncovering ways to reduce this liability, we then mapped out projections of how the proposed strategy would benefit Macy's in future periods. Of course, much of this paper remains speculative, as the mentioned strategies may hinge on the occurrence of probable future events. Nevertheless, planning for estimated likely outcomes is necessary for companies who attempt to minimize their tax liability.

From this case, our group has learned new information and skills that will improve both our end of semester case performance and our professional performance. First, at a base level, analyzing how companies handle tax developments gives us another perspective as future accountants. Much of our accounting work thus far in prior classes has been related to recording transactions and ensuring account balances remain correct throughout a given process. Here, we are observing our company's environment, applying tax advisory services a step further than reviewing transactions. Additionally, this case is our first direct attempt to apply numerical projections to our data. Shifting our solutions from qualitative to quantitative observations is key to proving your points in the professional and academic worlds.

Political Developments

To provide background for the case, in a few weeks, midterm elections will shift the ideological makeup of Congress. Over the past few years, there has been a progressive majority

in government, containing a liberal House of Representatives and a split Senate. In those years, it might have been easier to predict possible changes to tax policy, as democratic policy would be more likely to be enacted than more conservative policy. However, with the insertion of the coming midterm elections, tax planning for the next year may be more difficult to readily determine.

It is most likely the conservative party will win back the House of Representatives in the midterms. The Senate, however, remains contested, as there is no prevailing opinion on who might consolidate control. Thus, cumulatively, conservatives will likely gain more than they lose, which, historically, is not an anomaly. In recent midterm elections, the party with the sitting President in power typically loses congressional seats. This is not expected to change, as the Biden presidency has struggled to garner high approval ratings among Americans. As far as tax planning is concerned for Macy's, it is difficult to assess whether there will be tax code changes as a result of the elections. Even with conservatives favored to hold a majority in the House of Representatives and maybe the Senate, the Executive Branch's veto power will likely prevent sweeping conservative changes. This effect goes both ways, as the Biden presidency will likely face stiffer resistance to accomplish progressive goals with a conservative Congress.

As a result, it is difficult to determine whether there might be any major change over the next few years in tax policy. For additional context, the last major change in tax policy came in 2017 with the Tax Cuts and Jobs Act (TCJA). This change occurred during an overwhelmingly conservative majority, with all three branches of government leaning right. And, most recently, the Biden administration was unable to pass the Build Back Better Act, which contained a multitude of tax changes, including an increase in the corporate tax rate, even with a mainly democratic Congress. Although some tax changes were implemented later in the Inflation

Reduction Act, like an excise tax on stock buybacks and a 15 percent minimum tax on corporations earning more than $1 billion dollars in income (Kiplinger), a likely split government over the next two years makes it difficult to predict how future tax changes will occur.

Notable Tax Credits

Work Opportunity Tax Credit

Overview

A notable tax credit that Macy's should implement is Work Opportunity Tax Credit (WOTC). According to the Department of Labor, WOTC is "a federal tax credit available to employers who invest in American job seekers who have consistently faced barriers to employment" (DOL). Retail employers who hire an individual in a WOTC targeted group can claim a tax credit. There is a certification process that Macy's would have to go through with the new hire verifying that they are a member of the targeted group. Once this certification is complete, Macy's can then claim the tax credit. This would show us as a general business credit against income taxes for Macy's.

There are many people who can be considered a part of the WOTC target group. For example, ex-felons are qualified to be a part of this program so long as it is within a year of them being convicted of a felon and being released from prison. Another example is a long-term unemployment recipient. These are people who have been unemployed longer than 27 consecutive weeks.

According to Corporate Tax Incentives, a typical clothing business like Macy's can have an annual WOTC benefit of $4,604,268 with 35,692 hires at $129/hire (CTI). The program is

only authorized until December 31, 2025, so Macy's would have to utilize this tax credit before then.

So, to specifically tailor the WOTC to Macy's, what aspects of the WOTC most align with Macy's business and simultaneously minimize tax liability? To start, Macy's experiences employee turnover more than the industry average, meaning Macy's constantly has to address the challenge of finding new employees to fill positions (UKEssays). Of course, rehiring and training costs affiliated with the turnover harm Macy's, but Macy's can take advantage of this challenge for tax purposes. The maximum tax credit that can be vested per employee is $2,400 (irs.gov). This credit depends on a variety of factors, including the length of time the employee worked, the amount of pay the employee receives, and, obviously, whether the employee is a member of a qualified group for the credit. In addition, this employee must be a completely new hire for the company: Macy's cannot rehire employees from a qualified group and expect a credit.

Credit Computation Analysis

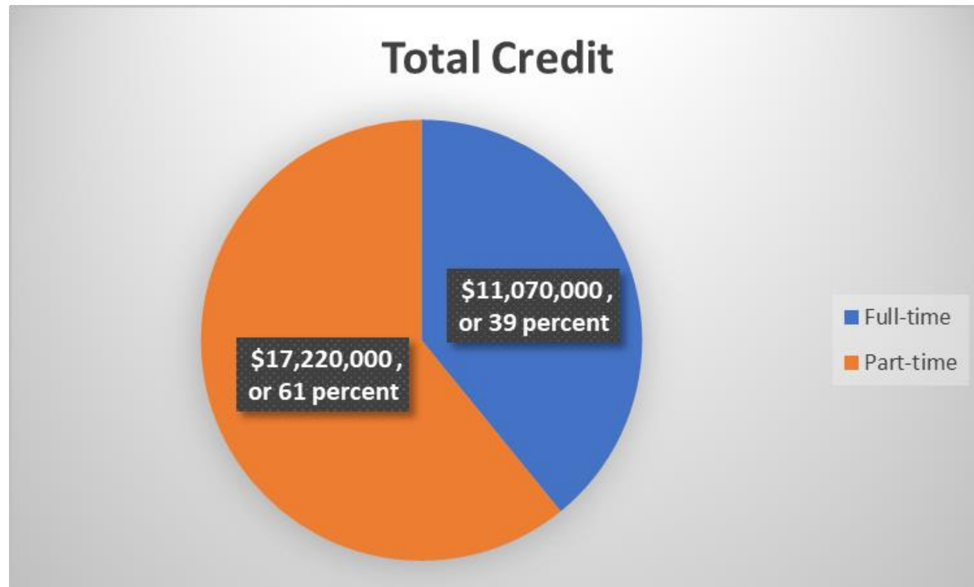
The aim of this analysis is to assess how much this credit may benefit Macy's. Of course, there must be assumptions made as to how many employees are hired in a given year, what proportion of these hired employees fit the WOTC, and what the expected credit outcome may be for each employee on average, as it is unreasonable to expect each employee would reach the maximum benefit of the credit.

To start our list of assumptions, we must first find a given number of newly hired employees to base our analysis. For this holiday season, Macy's plans to hire more than 41,000 full and part-time employees (macysinc). And, to limit our analysis from getting too broad, we

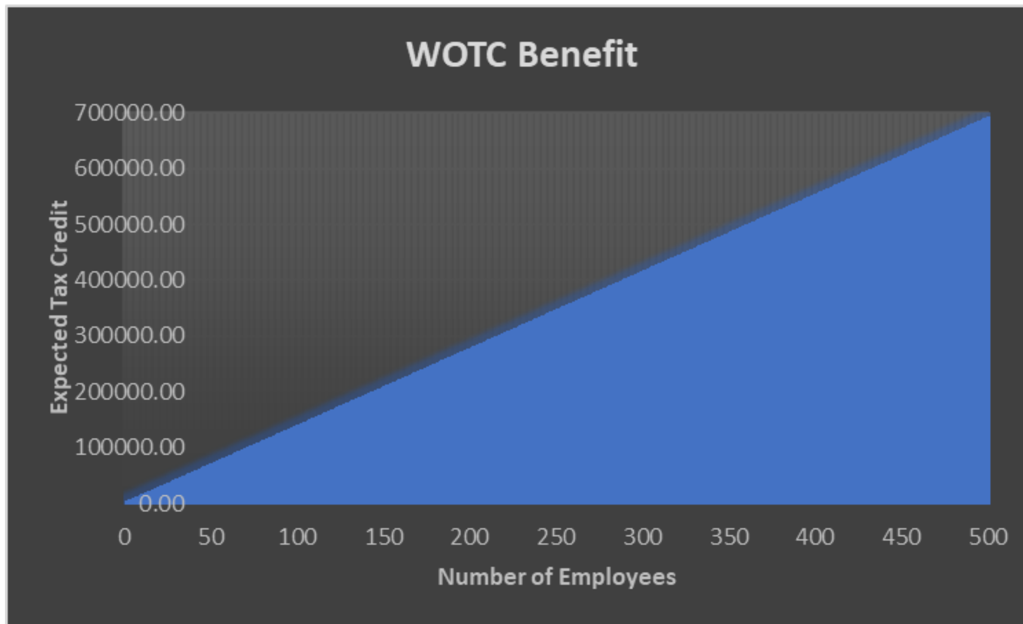
will just take this 41,000 as our employee base for computing the tax credit and assume they are all completely new hires. We will also assume that roughly half of these employees qualify for the WOTC. Realistically, this proportion will depend on Macy's willingness to maximize this credit, although it is understandable if the company fails to find employees that fit the various qualified groups or if there are simply higher performing employees available. Nevertheless, this reduces our employee credit base to 20,500.

From here, we must now fill the assumption of how much of the WOTC applies to each employee. Given these new hires were hired during the holiday season, it is reasonable to assume most are part-time employees. For this exercise, we will assume 70 percent, or 14,350 employees, are part-time, with the remaining 6,150 employees being full-time. Fortunately for Macy's, the WOTC does not specify whether the employee has to be a full-time worker, so the part-time employees are included in the credit computation.

And, finally, we must now dictate how much the average credit would be based on the employee groups. Given part-time employees would log fewer hours and likely be paid less, the WOTC would be less. For this experiment, we can assume the average part-time credit would be $1,200, and the average full-time credit would be $1,800. From here, we can perform our basic analysis.



To sum up, the overall tax credit would be a little over $28 million. However, in reviewing Macy's annual report, its combined federal tax credit over the last three reportable periods was only $11 million, making the projection look unrealistic, even with the seasonal employee base used. However, looking at the data another way, we might be able to contrive a more realistic outlook of the benefits this credit may provide Macy's. If 70 percent of employees receive a $1,200 credit, and 30 percent receive an $1,800 credit (from credit assumptions per employee type listed above), we can provide another visualization of the data.



Here, we have a linear graph of the expected tax benefit based on the number of employees hired. From the average tax credit from each type of employee previously listed, we calculated a weighted average of $1,380 WOTC per employee hired who qualifies under the WOTC. As seen in the graph, this credit quickly accumulated based on these parameters, and if Macy's can hire 250 employees who qualify, the expected tax credit would be $345,000. Given the employee turnover Macy's is facing combined with its seasonal hiring nature that the Work Opportunity Tax Credit would help mitigate Macy's tax liability moving forward until its expiry in December 2025.

Qualified Opportunity Zones

Another tax credit that could be used would be to invest in Qualified Opportunity Zones (QOZs). This tax incentive was designed to bring investors to distressed communities, with the thought that their investments would bring economic benefits. These areas are nominated by

their state and approved by the U.S. Treasury. The IRS goes on to further explain QOZs and their tax benefits by stating, “Opportunity Zones offer tax benefits to investors who elect to temporarily defer tax on capital gains if they timely invest those gain amounts in a Qualified Opportunity Fund (QOF)” (Opportunity Zones.) This Qualified Opportunity Fund helps investors defer taxes on their investments until there is an event that terminates the QOF, or December 31, 2026, whichever comes first.

These Opportunities Zones could be greatly beneficial to Macy’s if they are looking to expand and build more brick-and-mortar stores. There are currently over 8,700 opportunity zones located in the United States and Puerto Rico and more than 137 regional and super regional malls located within these opportunities’ zones. So, Macy’s will also have the option to repurpose a storefront instead of having to build its own if it so chooses (Campbell, Kyle). This includes distressed communities in almost every city and area. Macy’s would also need to hold this property for at least 5 years to start acquiring the benefits. After 5 years, 10 percent of the tax on existing capital gain is canceled. After 7 years, the payment of existing capital gains is deferred until December 31, 2022, and 15 percent of the tax on existing capital gains is canceled. Also, after 10 years investors pay no capital gains tax on Opportunity Fund investments (Willens, Jessica).

This could be an interesting move for Macy’s but would require them to start investing in areas that they may have overlooked or purposely passed over in the past. There are a lot of factors that play into this, such as why is the area so undesirable? Is this investment going to be profitable for Macy’s, would any segment of Macy’s have clientele in this area? Craig Bernstein, the principle and chief investment officer of OPZ, said, “The opportunity zones program has the ability to make a good deal great, but it won’t make a bad deal good. At the end of the day, the

deal still needs to stand irrespective of the tax benefits. You can't, under any circumstances, let the tail wag the dog (Campbell)". Basically, this program should be looked upon as an added incentive and not a cure-all. Utilizing opportunity zones could be beneficial for Macy's, but it would have to go through lots of deliberation and consideration by a potential Qualified Opportunity team.

Bonus Depreciation

Although not a tax credit, another tax element that Macy's should consider leveraging is the bonus depreciation advantage for the remainder of 2022 and moving forward. Simply put, bonus depreciation is the ability to immediately depreciate certain qualified assets used by a business. This provision was implemented in the Tax Cuts and Jobs Act (TCJA) in 2017. Up until the end of 2022, businesses are allowed to fully depreciate any of these qualified assets (up to 100 percent). Unfortunately, starting in 2023, bonus depreciation will drop to 80 percent, 60 percent in 2024, and 40 percent in 2025, and so on until it is no longer available in 2027 (thelangelfirm).

The qualified assets that are available for bonus depreciation are equipment, furniture, fixtures, machinery, and computer software, to name a few. And, perhaps most importantly with respect to Macy's, another depreciable qualified asset is "qualified improvement property," which are improvements made to commercial buildings (thelangelfirm). For such a brick-and-mortar company like Macy's, taking advantage of bonus depreciation may be instrumental in reducing their taxable income. According to Macy's prior annual report, property and equipment represented the largest asset on their balance sheet. If Macy's could fully or majorly deduct

portions of new transactions for the remainder of this year and next year through bonus depreciation, Macy's would certainly limit their tax liability.

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