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## Case Analyses in Financial Accounting

Jordan Watts

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CASE ANALYSES IN FINANCIAL ACCOUNTING

By

Jordan Watts

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 2020

Approved by:



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Advisor: Dr. Victoria Dickinson



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Reader: Dr. W. Mark Wilder

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## ACKNOWLEDGEMENTS

The first and biggest thank you goes to my parents and family who have made constant sacrifices for me and my education throughout my life and who have guided me in my endeavors to this day. I would also like to dedicate this thesis to the University of Mississippi and its generous supporters, without whom I could not have completed a university education. To my teachers and mentors, a sincere thank you for every conversation and word of wisdom which has guided me on my path, especially Dr. Victoria Dickinson, without whom this thesis and many other accomplishments in my time at the university would not have been possible. Finally, to the Sally McDonnell Barksdale Honors College staff, members, and supporters, I would like to thank you for my absolute favorite and most enriching part of my college experience.

## ABSTRACT

JORDAN OLIVIA WATTS: Case Analyses In Financial Accounting  
(Under the Direction of Victoria Dickinson)

The following thesis explores topics in the profession of public accounting, a diverse and ever-evolving field. As the global business environment and economy develop, so must accounting standards and ideas in order to protect the interests of the masses who invest and take part in the larger economy. The following cases expound on important concepts in the field of accountancy and provide careful consideration of standards utilized and debated worldwide. Each case is explored within the context of a different company or situation, allowing for a diverse palette of research topics from which to view the business world through an accounting lens. The case studies were completed under the direction of Victoria Dickinson in fulfillment of requirements for the University of Mississippi's Sally McDonnell Barksdale Honors College and Patterson School of Accountancy ACCY 420 course in the 2017-2018 academic year.

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# Apache Hadoop



Data Analytics Tools Analysis

By: Jordan Watts

The University of Mississippi



## Executive Summary

The most basic purpose of financial accounting is to identify, measure, and communicate financial information about economic entities to interested parties. Today one of the biggest challenges to achieving this goal is delivering timely as well as accurate information. Thanks to constantly improving data analytics technology, accountants have been able to deliver on these goals with increasing precision and speed. This profile on one particularly useful tool, Hadoop, illustrates how advantageous developments in data analytics can be for the accounting field.

I found research on the following data analysis tool, Apache Hadoop, to be very helpful in comprehending exactly what the purpose and capabilities of such technologies are and even a little bit how to utilize the actual program. This case entailed identifying general information about the use, functionality, and creation of a particular cutting-edge data analysis tool. Though the tools researched have many innovative uses in a variety of industries, this case explores the utility Hadoop could provide in the context of accounting. It explores ways that Hadoop and other data analytics tools could be used in both audit and tax settings.

## Analysis

**1. Identify the purpose of this tool, describe, in general, how it is used to make business decisions, and identify other resources that need to be in place to fully utilize the functionality of the tool.**

Though Hadoop's technology offers a variety of tools in different forms of software, the basic system is an open-source software framework capable of storing and

processing massive amounts of data quickly. Hadoop in and of itself is a free software framework formed by a non-profit organization, but many variations exist commercially (such as Cloudera) which have been set up for easy installation and implementation and are more user-friendly, as some expertise is required to operate the initial framework. These commercial products usually offer some sort of training and support services for more efficient integration into the company's day-to-day work.

**2. What special skills are needed to use this tool to aid in business decision making? How might a student like yourself gain those skills?**

To utilize much of the commercial software offered, experience with Java is crucial. A student wishing to be hired by a firm that uses or is planning to use Hadoop should either take a course or learn online how to familiarize themselves with Java. The potential employee should also have Hadoop Database training before beginning to work with the system.

**3. How, specifically, would you use the tool in the following business settings? Create at least three specific scenarios for each category in which the tool would lead to more efficiency and/or better effectiveness. Be sure to describe what kinds of data your tool would use for each scenario.**

**a) Auditing**

There are a plethora of innovative and advantageous uses of Hadoop in the audit department. Namely, just one example of a commercial product of Hadoop, MapR, tracks tasks and logins performed by employees more efficiently, vizualizes audit information

quickly and easily, and creates heatmaps with data in large volumes for a variety of helpful reasons. Any sort of data entry can be logged using Hadoop, as well as every login or authentication attempt; tracking this information allows Hadoop companies to keep track of things like who touched customer records and when, what actions employees took before leaving the company, what changes were made without also performing a change control, and if some users are accessing sensitive files from secured IP addresses. These collections of essential information from large amounts of data protect the company while decreasing the time and resources spent on external audit. The next key feature of Hadoop aforementioned is the allowance for user discretion in sorting and visualizing the audit information; Hadoop is written in a popular format that allows products like Apache Drill to license individual users to use whatever usual Business Intelligence tool they prefer in tandem with Hadoop interfaces. Finally, the use of heatmapping opens an entire new realm of beneficial possibilities for the field of audit. By taking a snapshot of data with high frequencies, much can be learned about the company's intricate operations. For example, it is possible to track if a lot of products are coming back as warranty goods, which transactions are being recorded near a year's end, and it is possible to compare the times of transaction recordings and shipping points/customer receipts.

#### **b) Tax Planning**

Heatmapping also has advantageous implications in the realm of tax accounting. For general business operation purposes, it is helpful to ensure that the frequently accessed data can be found at a different location in case of user errors that may erase or overwrite important data; this could also ensure that company operations could continue

even in the case of some failure in the main data center. Furthermore, a company's tax needs will change and need modification as a company grows from period to period, and Hadoop's flexible system offers readily available additions and upgrades for every stage as the needs develop. One of the main goals of tax accounting is to aid companies in efficient tax spending, such as finding their lowest possible taxable income, favorable tax environments for building and expansion, and forecasting future profitability. Hadoop has the ability to sort through massive amounts of data to predict just these items, catching qualities in the data that the human eye may miss.

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

Memorandum

To: (Insert Future Accounting Partner Name)  
From: Jordan Watts  
Date: May 2020  
Re: Integration of Apache Hadoop

The marginal benefit of integrating Hadoop into our data systems will be a more-than-generous asset to our company. We can utilize its functions in tandem with all our current business intelligence programs, and its assistance with both our tax and audit departments would be incredibly advantageous; its functions could run all of our clients' data and remove substantial human error, catching things that even our best employees would miss, as well as insuring that our day-to-day functions will continue even if disaster strikes our main data system.

The implementation of any new data system into a company will come with costs such as the time, money, and energy that goes into training employees, but each of these challenges have simple, cost-effective solutions with Hadoop. It is one of the lowest-priced products on the market because of its scaling capabilities, and vendors offer training and support services for more efficient integration into the company's current data system. Some critics point out that a similar product, Spark, is faster, but these two products can be paired for desired speed (they actually have the same creator) and Hadoop offers more key features. Furthermore, its benefits for companies with data magnitudes of our level are innumerable.

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

Signed Jordan Watts (electronic signature)

# Rocky Mountain Chocolate Factory, Inc.



Financial Audit and Analysis

By: Jordan Watts

The University of Mississippi



## Executive Summary

This particular case walked through the accounting cycle for Rocky Mountain Chocolate Factory. It started with journalizing transactions and flowed all the way through the development of a trial balance, adjusting entries, an adjusted trial balance, financial statements, and the closing process. I learned a lot about Excel's convenient tools for these kinds of projects as well as gained a lifelike experience with developing a company's accounting cycle.

Topics that are analyzed and discussed in this case include industry expectations for the financial statements of a retail and franchise- centered company as well as expected adjustments to be made to these financial statements. The completed and balanced financial statements are then provided in order to provide comparison to initial expectations. This case was a helpful practice in developing industry expectations to develop a starting point for assessing the accuracy of a company's financial statements, and also provided insight into the basics of testing accounting entries and ensuring the mathematical accuracy of the financial statements, which are auditors' responsibilities.

## Analysis

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

Because the company earns its revenues from production and sale of chocolate as well as

from company-owned stores, but then also from retail and franchises, I expect the Balance sheet to reveal a lot of inventory and property, plant, and equipment on the assets side.

I expect some current payables and long-term loans to constitute its major liabilities.

**2. Based on the transactions recorded, list at least three adjustments or reclassifications that might need to be made prior to preparing the final financial statements.**

Already you can tell that adjustments may need to be made for more accrued wages at period end, for use of inventories from the suppliers in (4), and to adjust the prepaid service fee in (8) because the company must provide services for five years.

Figure 2-1: Rocky Mountain Chocolate Factory, Inc. General Ledger

General Ledger			
1	Inventories	7,500,000	
	Accounts Payable		7,500,000
2	Inventories	6,000,000	
	Accrued Salaries & Wages		6,000,000
3	Cash	17,000,000	
	Accounts Receivable	5,000,000	
	Sales		22,000,000
	Cost of Sales	14,000,000	
	Inventories		14,000,000
4	Accounts Payable	8,200,000	
	Cash		8,200,000
5	Cash	4,100,000	
	Accounts Receivable		4,100,000
6	Sales & Marketing	1,505,431	
	General & Administrative	2,044,569	
	Retail Operating	1,750,000	
	Cash		2,000,000
	Other Accrued Expenses		3,300,000
7	Accrued Salaries & Wages	6,423,789	
	Cash		6,423,789
8	Cash	125,000	
	Deferred Income		125,000
9	Property & Equipment	498,832	
	Cash		498,832
10	Retained Earnings	2,407,167	
	Dividends Payable		3,709
	Cash		2,403,458
12	Cost of Sales	216,836	
	Inventories		216,836
13	Depreciation & Amortization	698,580	
	Property & Equipment		698,580
14	General & Administrative	639,200	
	Retail Operating	6,956	
	Accrued Salaries & Wages		646,156

## Financial Statements

*Figure 2-2: Rocky Mountain Chocolate Factory, Inc. Income Statement*

Rocky Mountain Chocolate Factory, Inc. Income Statement For the year ended 2/28/2010		
<b>Revenues</b>		
Sales	22,944,017	
Franchise and royalty fees	5,492,531	
<b>Total revenues</b>		28,436,548
<b>Costs and Expenses</b>		
Cost of sales	14,910,622	
Franchise costs	1,499,477	
Sales & Marketing	1,505,431	
General and administrative	2,422,147	
Retail operating	1,756,956	
Depreciation and amortization	698,580	
Total costs and expenses		22,793,213
<b>Operating income</b>		5,643,335
<b>Other Income (Expense)</b>		
Interest income		27,210
<b>Other, net</b>		27,210
<b>Income Before Income Taxes</b>		5,670,545
<b>Income Tax Expense</b>		2,090,468
<b>Net Income</b>		3,580,077
<b>Basic Earnings per Common Share</b>		0.595417513

Figure 2-3: Rocky Mountain Chocolate Factory, Inc. Balance Sheet

Rocky Mountain Chocolate Factory, Inc. Balance Sheet 2/28/10	
<b>Assets</b>	
<b>Current Assets</b>	
Cash and cash equivalents	3,743,092
Accounts receivable	4,427,526
Notes receivable, current	91,059
Inventories	3,281,447
Deferred income taxes	461,249
other	220,163
<b>Total current assets</b>	<b>12,224,536</b>
<b>Property and Equipment, Net</b>	<b>5,186,709</b>
<b>Other Assets</b>	
Notes receivable, less current portion	263,650
Goodwill, net	1,046,944
Intangible assets, net	110,025
Other	88,050
<b>Total other assets</b>	<b>1,508,669</b>
<b>Total assets</b>	<b><u>18,919,914</u></b>
<b>Liabilities and Stockholders' Equity</b>	
<b>Current liabilities</b>	
Accounts Payable	877,832
Accrued salaries and wages	646,156
Other accrued expenses	946,528
Dividends payable	602,694
Deferred income	220,938
<b>Total current liabilities</b>	<b>3,294,148</b>
<b>Deferred Income Taxes</b>	<b>894,429</b>
<b>Commitments and contingencies</b>	
<b>Stockholders' Equity</b>	
Common stock	180,808
Additional paid-in capital	7,626,602
Retained earnings	6,923,927
<b>Total Stockholders' equity</b>	<b>14,731,337</b>
<b>Total liabilities and stockholders' equity</b>	<b><u>18,919,914</u></b>

Figure 2-4: Rocky Mountain Chocolate Factory, Inc. Balance Sheet

Cash Flows	
Transaction	Section of Cash Flows
1. Purchase inventory	Operating
2. Incur Factory wages	Operating
3. Sell inventory for cash and on account	Operating
4. Pay for inventory	Operating
5. Collect receivables	Operating
6. Incur SG&A (cash and payable)	Operating
7. Pay wages	Operating
8. Receive franchise fee	Operating
9. Purchase PPE	Investing
10. Dividends declared and paid	Financing
11. All other transactions	N/A
12. Adjust for inventory count	Operating
13. Record depreciation	N/A
14. Wage accrual	Operating
15. Consultant's report	N/A

# Topics in Professional Ethics

By: Jordan Watts

The University of Mississippi

## **Executive Summary**

In this case I learned a lot about making career decisions and debated the ethics, advantages, and disadvantages about various paths that accounting majors are able to take. The debate consisted of three scenarios, each of which had two points of view to argue from. In each situation a student was making a decision concerning internship employment that could have unforeseen consequences but also could further his or her own career path.

The three major student categories were a potential tax law student, two accounting majors who actually wanted to go into investment banking and finance, and a student who had just completed an internship in Washington, D.C. who wanted to return to his hometown of Dallas. Each of us were asked to choose to either side with the student's interests or debate against them if we thought what they were doing was wrong.

## **Debate #1: Tax Law**

The first scenario was a student expressing a desire to graduate with an undergraduate degree in accounting, but seeking to go to law school immediately after his internship senior year. He remarks this and his reasoning behind it to another student.

The student clearly has an ambitious career path and intends to put himself on a high-achieving path, but his argument for his plan of action is not entirely sound. He claims that accounting graduates who become employed at a law firm as a tax lawyer are paid more than CPAs, but the opportunity cost would be greater than the benefit because though there is about a \$20,000 advantage for a tax lawyer at a law firm for the first few years of work, the pay for CPAs catches up after two to three years while the law student



typically has debt to pay off as well. So, unless he is truly very passionate about law school, his career plan does not seem to have any truthful benefit.

I also believe there is something to be said about transparency when being hired by a firm. If the firm does not know that this student plans to attend law school immediately after his internship, they are being misled to believe he wants to become a full-time hire afterwards. It is true, as some students mentioned, that it is much harder to attain legal internships than accounting ones with firms, but it still does not seem beneficial for anyone involved to mislead a firm into believing that the student is a potential full-time hire when he is not.

### **Debate #2: Private Investment and Finance**

In the second set of students' conversation, one individual sought to go into investment banking while the other wanted to go into finance, yet both students identified as accounting majors with desires to secure internships with accounting firms. I have to agree with them that an accounting degree is very advantageous to those two and many more career paths, but I would again argue that if they want to take accounting internships, they need to be careful about being completely transparent with the firms they interview with. Neither of them were specific on their timing plans, but it did not seem like they aimed to get their CPA license, which is something that I believe should be disclosed to the firms.

However, I fully support using an accounting undergraduate major for those career paths and believe that those students could definitely get internships in the departments they are truly interested in rather than wasting both theirs and the firms' time

and resources for a semester. Although some students disagreed that the students should disclose their career goals because, and I quote, “There are no common courtesies in corporate America,” I would argue that full disclosure is one of the main principles of financial accounting and that hiding true career plans from an employer is simply bad accounting.

### **Debate #3: Changing Locations**

With the final scenario, a single student sends an email to an old professor seeking advice on changing locations from Washington, D.C. to his hometown of Dallas, Texas. He completed his undergraduate internship in D.C. with a “Big Four” firm, and it is not explicitly clear why he wants to leave, but he does explain that he had intentions to move away and regrets it, so it seems like he had no malintentions to mislead the firm.

I think that the professor’s email was honest and appropriate, and do not believe there is anything wrong with the student reaching out to someone he trusted the opinion of, especially in a somewhat sensitive situation that he did not have experience with. I also believe that it is fair on the firm’s part to keep him in Washington, D.C. for a longer period of time than he may want in order to recoup the resources they spent recruiting and training him. But ultimately, if he would be happier in Dallas, I do believe it was good to let the firm know at the point that he did.

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

Signed Jordan Watts (electronic signature)

# Generic Bank

## Security Sales Practices

By: Jordan Watts

The University of Mississippi

## Executive Summary

In this case I had to carefully examine Generic Bank's typical practices in holding and selling AFS debt securities. These securities are currently standing at a lower fair value than their amortized cost, meaning that when the bank sold seven of these securities, a loss had to be recognized. I was asked to determine whether a loss should have been incurred at the time when intent to sell (at the end of 20x2 in order to free up cash) was shown, rather than only reporting at the date of sale in 20x3. I then had to determine whether this sale affected the bank's claim of intent and ability to hold the remainder of its securities.

By working on this case I was exposed to different specific mandates of US GAAP and their implications in the world of accounting. I learned to research different advisory bulletins in order to form an opinion on an ambivalent issue. This case was particularly interesting because it delved into a widely debated topic which could affect accounting practices everywhere in the future and therefore have substantial economic implications.

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

The seven AFS debt securities that were sold definitely suffered a loss from the amortized cost to fair value, as their fair value has dropped below the amortized cost. Under ASC 326-30 and ASU 2016-13, to determine how to account for this loss, the standard considers whether or not the bank either has intent to sell the security or will be

required to sell the security before the fair value once again reaches the amortized cost amount. In the case of a probability of sale there must be a write-down recorded to get the securities to their fair value. Because at the end of the year the CFO knew that the bank needed to free up cash and he was considering selling the securities at a point when they were valued lower than their amortized cost, an allowance for the loss should have been accounted for in 2012 because the impairment of the securities is impairment of an asset, which under US GAAP must be recorded when an asset's carrying amount is not recoverable (Iasplus.com), meaning the expected future cash flows from the asset are lower than the carrying amount. This point would have occurred in 2012 when it was realized that the bank was considering selling the debt securities at an impaired level.

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

In the case it is noted that the bank must be able to assert that a) the securities have no credit impairment, only temporary losses, and b) it has the intent and ability to hold the securities until prices recover. Both of these items are addressed in order to prove that Generic Bank should not have impairment losses on the remainder of their securities after selling seven of them in early 20x3. If we are treating the assertion that Generic Bank's declines in debt securities are related mainly to changes in interest rates and not credit deterioration as reasonable, and then consider the fact that the terms of the bonds mandate that the securities cannot be settled for less than their amortized cost, we

must conclude that this bank meets criteria a. In a staff response from the Office of the Comptroller of the Currency's Bank Accounting Advisory Series, the numerous factors that can indicate impairment due to credit loss are listed, and none seem to apply to this bank. Though it is noted that the loss is material to the bank, there are no adverse conditions related to the securities (no particular information that looks ominous about the financial condition of the mortgages that back the securities), no nontraditional terms, and no failure to make interest or other payments ("Credit").

The CFO is worried that the sale of the seven securities will affect facet b, General Bank's assertion of intent and ability to hold the other securities until they return to at least their amortized cost value, but it is made clear that the bank has other means to raise funds if necessary, and that the desire for such liquidity was only a voluntary action, so it definitely has the ability to hold the securities. As for the intent to hold the securities, it is stated that "the extent of rebalancing sales is usually only a small portion of the overall portfolio." This indicates that even if the bank were to sell more of its securities, it would likely not be very many of them; this means that the only real claim one could make to assert that the AFS securities are impaired is that the typical amount sold at General Bank's regular portfolio rebalancings should be written down to fair value. This way, there could be perceived intent to sell this small amount before they recoup the loss. However, there is no indication that the bank actually plans to rebalance again before the securities rise once again to amortized cost value, and it must be deemed probable that they will sell in order for GAAP to mandate that the securities must be reported as impaired ("Credit"), so the remainder of the securities should be accounted for without impairment.

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

My answer would not change either way. As stated in question three, the only argument able to be made for the credit securities' impairment is the slight possibility that the bank would voluntarily sell a few more of the securities, and even that does not meet the probability requirement. Bank regulators are subject to more scrutiny on ethics, so their considerations may be more inclined to at least disclose the truth about the current loss somewhere where investors can find it, and the auditor could feel that full disclosure may encompass this as well, but as far as their legal requirements for disclosure on the financial statements go, the answer remains the same.

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

If the securities sold had been collectively in a net gain position, that would definitely be misleading because it covers up the fact that there are indeed large current losses on the securities. According to the FDIC Manual of Examination Policies, this action could be considered gains trading, where securities acquired cannot be sold at a profit are kept AFS while others are sold, which defers loss recognition. If this occurred and an examiner considered it gains trading, their actions would consist of consulting



with a Regional Office for guidance on how to account for and clearly designate these securities as trading assets (“Securities”).

**-- Now assume that Generic Bank is adequately capitalized rather than well capitalized. And the bank desires to sell securities to improve capital ratios (through the reduction of risky assets) and to fulfill other borrowing obligations as they come due. Securities may not represent the only assets available to Generic Bank to sell, but access to other forms of borrowing to meet liquidity needs has become more limited. --**

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

Yes, now there is an impairment loss on more than the securities sold. Now the selling of securities is no longer a voluntary action for a company strategy but a way to make their reports look better. The bank no longer has the intent and ability to hold the securities until prices recover, as it is clear that selling the securities is now the easiest way to free up cash and the bank is already clearly intending to sell them. The loss should be accounted for by writing down the other securities that will probably be sold before they are able to return to their amortized price (“Credit”).

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

Signed Jordan Watts (electronic signature)

# City Comparisons

Potential City Choice Evaluations

By: Jordan Watts

The University of Mississippi

## Executive Summary

This case was particularly helpful in discerning which cities are most compatible with the potential career I want to hold. The factors of city choice which were most important to me were the ones that actually pertained to the job, such as which clients I will be able to work on, and Boston and New York both have such interesting clients. I also love living in large cities, so both of the choices suit my interests in that department. Another huge part of city choice for me was considering what career I want after 3-5 years of being a CPA.

As of now, I would like to look into careers with the United Nations, and both New York City and Boston hold opportunities where I could work closely with this organization. I of course learned a lot when considering all seventeen of the questions, particularly where taxes, healthcare, rent, and budgeting were concerned. Any big move can be intimidating, so it was very helpful to get a little bit of the potential city research out of the way.

### **1. What is the population?**

New York City: 8.623 million (2017)

Boston: 685,094 (2017)

## 2. Describe the climate and seasonal fluctuations.

### Boston, MA

Weather averages

[Overview](#) [Graphs](#)

Month	High / Low (°F)	Rain
January	37° / 22°	8 days
February	39° / 24°	7 days
March	46° / 31°	8 days
April	57° / 41°	8 days
May	67° / 50°	8 days
June	77° / 59°	8 days
July	82° / 66°	6 days
August	81° / 65°	6 days
September	73° / 57°	6 days
October	62° / 47°	7 days
November	52° / 38°	8 days
December	42° / 28°	9 days

### New York, NY

Weather averages

[Overview](#) [Graphs](#)

Month	High / Low (°F)	Rain
January	39° / 27°	8 days
February	42° / 28°	6 days
March	50° / 35°	8 days
April	62° / 45°	8 days
May	72° / 54°	9 days
June	80° / 64°	8 days
July	85° / 69°	8 days
August	84° / 68°	7 days
September	76° / 61°	7 days
October	65° / 50°	6 days
November	54° / 42°	7 days
December	44° / 32°	8 days

## 3. Describe the city's topography, scenery, and other geographic or geological features of the area in which the city is located. Include pictures where appropriate.

Both locations are large cities near major bodies of water but with suburbs some workers commute from, though New York is on a much larger scale.



New York:



Boston:

**4. What are the individual tax rates within the city (e.g., consider federal, state and local income tax, property tax, and any other taxes you'd be likely to pay. Quantify what this means based on a starting salary of approximately \$50,000/year)?**

New York

Boston

Federal Income Tax

- \$4,370

State Income Tax

- \$2,403

Social Security

- \$3,100

Medicare Tax

- \$725

**Total tax**

**- \$10,597**

**Net pay**

**\* \$39,403**

Federal Income Tax

- \$4,370

State Income Tax

- \$2,371

Social Security

- \$3,100

Medicare Tax

- \$725

**Total tax**

**- \$10,566**

**Net pay**

**\* \$39,434**

## **5. What transportation hubs are in the city?**

Both cities' transportation systems include roadway, subway, regional rail, air, and sea options for transportation. In Boston there are major renovations planned for the three largest transportation hubs.

## **6. What is the city's most prevalent industries?**

These two cities' primary industries are one of my main attractions to them. New York's top six leading industries are actual leading drivers on a national and global scale: Financial services, health care, professional and technical services, retail trade, manufacturing, and educational services. Meanwhile, Boston claims education, biotechnology, tourism, and financial services as its major industries. To me, these industries seem to be the most interesting, important to the economy, and have the most room for growth.

## **7. Describe the quality of the city's healthcare.**

Boston currently ranks as one of the best cities in America for healthcare and research. New York City, on the other hand, faces a huge challenge in this department because of the population density, but new initiatives and developments surface constantly.

## **8. What types of crime are common within the city and where are the locations within the city to avoid?**

In New York City, property crimes are very common with larceny/theft leading by a huge amount; the violent crime rate is also much higher than the national average, with



aggravated assault and robbery as the two leading categories. It is said that it is best to avoid Brooklyn Heights, Boerun Hill & Dumbo, Chelsea & Hell's Kitchen, Bedford-Stuyvesant, Downtown, Fort Greene & Clinton Hill, Flatiron, Brownsville, Hunts Point, Greenwich Village & Meatpacking District, and Midtown.

Boston's crime rate is actually only one percent higher than the national average, with violent crime a little higher and property crime a little lower than average. Once again, assault and theft were very common. In Boston it is said that one should avoid Roxbury, Chinatown, Fake Cheers, Allston/Brighton, and Fenway Park if wearing a Yankees hat.

**9. Based on where you see yourself living for the first three years, how much rent do you expect to pay? Back up this assertion with sample properties from each location (including pictures). Describe the square footage, amenities, need for a roommate, availability of parking, etc.**


In both cities, rent will be very high. In New York, most landlords will only approve renters whose gross annual income is 40 times the monthly rent, so I looked at places in the \$700-\$1000 range. I will most definitely find roommates and will not even bother with a car, but it seems very likely that I will be paying in that range. The following \$700 single in Manhattan (Image 5-1) is 63 square feet with very little amenities. The second (Image 5-2) is \$975 with 175 square feet, and they go up from there.

Image 5-1

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< Back Manhattan, NY x Q New York > New York County > Manhattan > 206 W 84th St Unit 2-203 < Prev | Next Property >

Presented by: **Aaron Barnes**  
Brokered by: **Exit Realty Landmark**



Home For Rent 1 / 17

**Contact this property**

Your Name  
Email  
Phone (optional)  
11/07/2018  
I'm interested in 206 W 84th St Unit 2-203  
 Send me news, tips and promos from realtor.com® using my email.  
**Send**  
By sending a request you agree to our Privacy Policy

Get a Free Moving Quote

0 63  
beds sq ft  
\$700 /mo  
Get a FREE Quote from GEICO


Map 206 W 84th St Unit 2-203, Manhattan, NY 10024

Save this Home

Image 5-2

< Back Manhattan, NY x Q New York > New York County > Manhattan > 347 5th Ave Rm 609 < Prev | Next Property >

Presented by: **Michael Segerman with Dynamik Real Estate**



Home For Rent 1 / 1

**Contact this property**

Your Name  
Email  
Phone (optional)  
11/07/2018  
I'm interested in 347 5th Ave Rm 609  
 Send me news, tips and promos from realtor.com® using my email.  
**Send**  
By sending a request you agree to our Privacy Policy

Get a Free Moving Quote

0 175  
beds sq ft  
\$975 /mo  
Get a FREE Quote from GEICO

Map 347 5th Ave Rm 609, Manhattan, NY 10016


Check your Credit Scores for \$0

Save this Home

Add Note Share Hide

This (Image 5-3) is an Air BnB 2-bedroom in Boston that would be \$1,261 per month. It is slightly bigger than the options in New York but just as pricey; it does offer more amenities, however.

Image 5-3



**PRIVATE ROOM IN APARTMENT**  
**WB Quarters™ by STRB|Polished Cozy in Southie**  
Boston

**2 guests** 1 bedroom 1 bed 1 shared bath

**Self check-in**  
Easily check yourself in with the keypad.

This Quarters™ room is a unique offering from Short Term Rentals Boston that makes living in the heart of Boston affordable and easy. You have your own private room with a queen bed in a newly renovated building across the street from the Red Line Broadway Stop. The laundry room, kitchen and living room are shared amongst the guests of this building. The Quarters™ are our most popular offering for people who need to be in Boston but don't have the need or budget for a full apartment.

**\$1,261** per month  
★★★★★ 3

**Dates**  
01/01/2019 → 03/09/2019

**Guests**  
1 guest

Accommodation ?	\$2,767
Cleaning fee ?	\$50
Service fee ?	\$265
<b>Total</b>	<b>\$3,082</b>

[View Photos](#)

**10. What is the typical mode of commuting? Based on your answers identified in the prior question, what are your likely commute times?**

I will definitely utilize the public transportation system for both cities. From older students making this transition, I understand that in New York my commute will probably not be long (other out of state students I will be rooming with and I will want to live close to the job) so maybe 15-25 minutes. In Boston, depending on which apartment

I choose, it could be 30-45 minutes if I do not live close to the job (though I would want to).

**11. Where will you do your grocery shopping?**

In both Boston and New York, grocery shopping will be very minimal. Especially if working for a Big Four accounting firm, I will eat out for most meals but probably keep some items like yogurt, peanut butter, and oatmeal in my apartment, which I can grab from any corner drugstore.

**12. How will you do your laundry?**

In New York, my washer/drier will most likely be on-site (most of the cheaper apartments I looked at had this setup). In Boston, there were actually some places with in-unit washer/drier setups.

**13. Name at least three civic, religious, or charitable organizations you would like to be active in for each city?**

In either city, I will be sure to explore the Catholic churches in the area and choose my favorite to attend each Sunday, and I would love to volunteer at a homeless shelter or an immigration center. One of New York's most attractive assets to me is the United Nations Headquarters. I plan to get involved with United Nations volunteer work whenever I can; I would actually like to explore eventual job options with them as well.

In Boston, I would like to be involved with the Poverty Action Lab at MIT as well as volunteer at an immigration center.

**14. What are the sports, entertainment, or recreational activities that you would be most likely to engage in within the city. Name at least five activities.**

NYC: Tennis league, workout classes membership, concerts, 10Ks/half marathons, and maybe the occasional sports games if friends ask

Boston: Tennis league, workout classes membership, concerts, Red Sox games, and 10Ks/half marathons

**15. What are the modes of traveling back to your hometown from this city? What is the average cost you'd incur for each trip back home?**

As I do not plan on bringing, a car, I would fly home. The plane tickets would be around \$500 each round-trip.

**16. Based on your findings, develop a model monthly operating budget for each city for Year 2, assuming that with bonuses for being a high performer, your annual salary is \$60,000.**

To be safe, I will go with the assumption that my net salary after taxes in both cities will be \$40,000 even, yielding \$3,333 per month.

	NYC	Boston
Rent/Utilities	\$1,500	\$1,500
Food	700	700

Transportation	200	200
Clothing/Household Purchases/Misc	200	200
Savings	433	433
Extra Spending Money/Emergency/Medical	300	300

**17. Finally, based on your full analysis, determine whether you still want to live in both cities, and if so, which one is your preferred city and why?**

I would definitely still consider these two cities my top two. This past summer I lived in a very small unit in a large city and rode public transportation and walked everywhere, and I loved it, so the only real drawback for me is how expensive it will be. It would be worth it, though to be able to work with the client base these two cities have to offer as well as to be able to explore potential eventual job opportunities with organizations I am passionate about, not to mention the constant entertainment both cities offer. Currently, New York is my preferred city because it has the United Nations Headquarters, the most interesting and diverse client base, the most room to grow in a career, and is honestly the same price as Boston, which is on a smaller scale.

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

Signed Jordan Watts (electronic signature)

WorldCom



Financial Audit and Ethics Analysis

By: Jordan Watts

The University of Mississippi



## Executive Summary

This case was particularly interesting because I actually learned the exact improper accounting behind the WorldCom scandal that I have heard so much about. It is a very good example of a case of the snowballing effect of poor accounting ethics decisions as well as an interesting concept to expound on in considering what kinds of loopholes companies may find when desperately seeking to meet earnings measures.

In this analysis, I explored exactly how FASB defines assets and expenses, when costs should be expensed or capitalized, and then how these determinations affect the bottom line of companies' financial statements. The exact accounting behind the fraudulent capitalization journal entries and subsequent depreciation is shown below, as well as how exactly the fraudulent bottom lines compare to the nonfraudulent, corrected journal entries and resulting financial statements.

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

**a. Explain, in your own words, how SCON 6 defines “asset” and “expense.”**

FASB defines an asset as a probable future economic benefit obtained or controlled by a particular entity as a result of past transactions or events.

Expenses, on the other hand, are outflows or other using-ups of assets and/or incurrences of liabilities during a period from delivering or producing goods, rendering services, or carrying out other activities that

constitute the entity's ongoing major or central operations.

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

In regards to property, plant, and equipment, generally, costs should be expensed when they simply maintain a given level of service and capitalized when they achieve greater future benefits for the asset.

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

After they are capitalized, they must be depreciated just like an asset. This depreciation decreases the net asset values on the balance sheet as well as increases the depreciation expense account, decreasing net income, but not by the amount of the total capitalization all at once, making it less detrimental to both the balance sheet and income statement than an expense of the same amount.

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

\$14,739,000,000

Journal entry (in millions):

Line cost expense	14,739	
		Accounts payable/cash
		14,739

These “line costs” were charges paid to local telephone networks to complete calls, loosely capitalized because they were, in a way, the means or infrastructure by which the company earned revenues, though they do not meet the criteria for PPE.

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

The costs that were improperly capitalized arose from multibillion-dollar contracts with third-party telecommunication firms meant to invest in fiber-optic networks, costs of which 15 percent were not producing revenue. The transactions that gave rise to these costs were charges paid to local telephone networks to complete calls. They do not meet my definition of assets because they are simply to maintain the level of service rather than to improve future benefits for an asset

or achieving future cash flows by themselves. As the case puts it, “One of accounting’s most basic rules is that capital costs have to be connected with long-term investments, not ongoing activities.” WorldCom instead intentionally wrongly capitalized these operating costs in order to defer them to periods when revenues may arise from them.

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

Journal entry (in millions):

Property, Plant, and Equipment	3,055	
	Accounts Payable/Cash	3,055

These costs appear under property, plant, and equipment improperly on the balance sheet (the cash or accounts payable amounts are still correct on the balance sheet) and statement of cash flows improperly under the investing section instead of the operating section.

6. **In a sworn statement to the Securities and Exchange Commission, WorldCom revealed details of the improperly capitalized amounts (in millions) in 2001: \$771 in the first quarter, \$610 in the second quarter, \$743 in the third quarter, and \$931 in the fourth quarter. Assume that WorldCom planned to depreciate these capitalized costs over the midpoint of the range**

**for transmission equipment as disclosed in note 1. Further assume that depreciation begins in the quarter that assets are acquired (or costs capitalized). Calculate the related depreciation expense for 2001. Prepare the journal entry to record this depreciation.**

Quarter 1:  $(\$771/22) * (12/12) = \$35,045,455$

Quarter 2:  $(\$610/22) * (9/12) = \$20,795,455$

Quarter 3:  $(\$743/22) * (6/12) = \$16,886,364$

Quarter 4:  $(\$931/22) * (3/12) = \$10,579,546$

Total= \$83,306,820

Depreciation Expense	83,306,820
Accumulated Depreciation	83,306,820

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

Income before income taxes and minority interests (reported in 2001)

2,393,000,000

Less capitalized costs (now expense)  
(3,055,000,000)  
Depreciation  
83,306,820  
Corrected net loss before taxes  
(578,693,181)  
Provision for Income Taxes, corrected  
202,542,613  
Minority interests  
35,000,000  
Net Income (loss)  
(341,150,568)

The difference is material because the capitalized costs were actually 127 percent of net income, a very substantial amount.

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

Signed Jordan Watts (electronic signature)

# Starbucks



Financial Audit and Profitability Analysis

By: Jordan Watts

The University of Mississippi



## Executive Summary

This case was a great introduction to analyzing financial statements. It required working with a Starbucks' reported statements from 2012/2013 and working through the challenges that auditors face in evaluating how fairly representative the statements were with regards to all of the nuanced legal policies for recognition of a public company's financials.

It was especially helpful to answer questions on the profitability of the company because it required a thorough analysis of profitability measures, some of which I had never considered before research. I had also never seen an actual example of a professional audit opinion letter, so it was beneficial to become familiar with the content and consider the specific legal implications that accounting firms take on with regards to their audit services.

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

Starbucks receives its major revenue streams from company-operated stores and licensed stores (not franchises). It sells mainly beverages but also food and merchandise at high gross margins to produce its healthy amount of income.

**2. What financial statements are commonly prepared for external reporting purposes? What titles does Starbucks give these statements? What does “consolidated” mean?**

Typical financial statements prepared for external reporting purposes are an income statement (and comprehensive income statement), a balance sheet, a statement of cash flows, and a statement of changes in stockholders’ equity. Starbucks calls these, respectively, the “consolidated statements of earnings/comprehensive income,” “consolidated balance sheets,” “consolidated statements of cash flows,” and “consolidated statements of equity.” Consolidated means that the financial statements combine a parent and subsidiary company.

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

Publicly traded corporations prepare financial statements for external reporting quarterly and yearly.

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

Company management is responsible for the preparation of financial statements. Potential users of the financial statements include potential investors, financial analysts, current stakeholders, and actual management of the company. Potential investors and current stakeholders are interested in shareholders’ earnings as well as

the overall health of the business as it pertains to their investments. Financial analysts want to know about earnings as well but also any indicators that might help predict the future value of stocks according to the market. Actual management is interested in how this information looks to investors, but is also concerned with how the business can be operated more efficiently.

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

Starbucks' external auditors are Deloitte & Touche LLP. They have included opinion letters which say that Starbucks' financial statements are a fair representation of their business, and that the company practices effective internal control over the reporting process. The opinions were issued on November 18<sup>th</sup> after year-end September 29<sup>th</sup> during 2013 because the financial statements would not have been issued until a period of time after the year-end, and the official audit opinion must come after that.

- 6. Use a spreadsheet to construct common-size income statements (which Starbucks calls statements of earnings) and balance sheets for 2013 and 2012. Common-size income statements scale each income statement line item by total net revenues (sales). Common-size balance sheets are created by dividing each figure on a given year's balance sheet by that year's total assets, thereby creating a balance sheet on a "percent of assets" basis. You will use these common-size statements in answering several of the questions below. (Starbucks' investor**

relations website—[investor.starbucks.com](http://investor.starbucks.com)—contains a link to SEC filings. The company’s Form 10-K can be found under annual filings and contains an Excel spreadsheet with financial statement data that may be helpful in creating the common-size statements).

Figure 7-1: Starbucks Consolidated Statement of Earnings

Consolidated Statements Of Earnings (USD \$) In Millions, except Per Share data, unless otherwise specified	12 Months Ended			
	Sep. 29, 2013	2013	Sep. 30, 2012	2012
<b>Net revenues:</b>				
Company-operated stores	\$11,793.20	79.19%	\$10,534.50	79.21%
Licensed stores	1,360.50	9.14%	1,210.30	9.10%
CPG, foodservice and other	1,738.50	11.67%	1,554.70	11.69%
Total net revenues	14,892.20	100.00%	13,299.50	100.00%
Cost of sales including occupancy costs	6,382.30	42.86%	5,813.30	43.71%
Store operating expenses	4,286.10	28.78%	3,918.10	29.46%
Other operating expenses	457.2	3.07%	429.9	3.23%
Depreciation and amortization expenses	621.4	4.17%	550.3	4.14%
General and administrative expenses	937.9	6.30%	801.2	6.02%
Litigation charge	2,784.10	18.70%	0	0.00%
Total operating expenses	15,469	103.87%	11,512.80	86.57%
Gain on sale of properties	0	0.00%	0	0.00%
Income from equity investees	251.4	1.69%	210.7	1.58%
Operating income	-325.4	-2.19%	1,997.40	15.02%
Interest income and other, net	123.6	0.83%	94.4	0.71%
Interest expense	-28.1	-0.19%	-32.7	-0.25%
Earnings before income taxes	-229.9	-1.54%	2,059.10	15.48%
Income taxes	-238.7	-1.60%	674.4	5.07%
Net earnings including noncontrolling interests	8.8	0.06%	1,384.70	10.41%
Net earnings attributable to noncontrolling interest	0.5	0.00%	0.9	0.01%
Net earnings attributable to Starbucks	\$8.30	0.06%	\$1,383.80	10.40%
Earnings per share - basic	\$0.01		\$1.83	
Earnings per share - diluted	\$0.01		\$1.79	
<b>Weighted average shares outstanding:</b>				
Basic	749.3		754.4	
Diluted	762.3		773	
Cash dividends declared per share	\$0.89		\$0.72	

Figure 7-2: Starbucks Consolidated Balance Sheet

<b>Consolidated Balance Sheets (USD \$)</b> <b>In Millions, unless otherwise specified</b>	<b>Sep. 29, 2013</b>	<b>2013</b>	<b>Sep. 30, 2012</b>	<b>2012</b>
<b>Current assets:</b>				
Cash and cash equivalents	\$2,575.70	22.36%	\$1,188.60	14.46%
Short-term investments	658.1	5.71%	848.4	10.32%
Accounts receivable, net	561.4	4.87%	485.9	5.91%
Inventories	1,111.20	9.65%	1,241.50	15.10%
Prepaid expenses and other current assets	287.7	2.50%	196.5	2.39%
Deferred income taxes, net	277.3	2.41%	238.7	2.90%
<b>Total current assets</b>	<b>5,471.40</b>	<b>47.51%</b>	<b>4,199.60</b>	<b>51.09%</b>
Long-term investments	58.3	0.51%	116	1.41%
Equity and cost investments	496.5	4.31%	459.9	5.60%
Property, plant and equipment, net	3,200.50	27.79%	2,658.90	32.35%
Deferred income taxes, net	967	8.40%	97.3	1.18%
Other assets	185.3	1.61%	144.7	1.76%
Other intangible assets	274.8	2.39%	143.7	1.75%
Goodwill	862.9	7.49%	399.1	4.86%
<b>TOTAL ASSETS</b>	<b>11,516.70</b>		<b>8,219.20</b>	<b>100.00%</b>
<b>Current liabilities:</b>				
Accounts payable	491.7	4.27%	398.1	4.84%
Accrued litigation charge	2,784.10	24.17%	0	0.00%
Accrued liabilities	1,269.30	11.02%	1,133.80	13.79%
Insurance reserves	178.5	1.55%	167.7	2.04%
Deferred revenue	653.7	5.68%	510.2	6.21%
<b>Total current liabilities</b>	<b>5,377.30</b>	<b>46.69%</b>	<b>2,209.80</b>	<b>26.89%</b>
Long-term debt	1,299.40	11.28%	549.6	6.69%
Other long-term liabilities	357.7	3.11%	345.3	4.20%
<b>Total liabilities</b>	<b>7,034.40</b>	<b>61.08%</b>	<b>3,104.70</b>	<b>37.77%</b>
<b>Shareholders' equity:</b>				
Common stock (\$0.001 par value) - authorized, 1,200.0 shares; issued and outstanding, 753.2 and 749.3 shares (includes 3.4 common stock units), respectively	0.8	0.01%	0.7	0.01%
Additional paid-in capital	282.1	2.45%	39.4	0.48%
Retained earnings	4,130.30	35.86%	5,046.20	61.40%
Accumulated other comprehensive income	67	0.58%	22.7	0.28%
<b>Total shareholders' equity</b>	<b>4,480.20</b>	<b>38.90%</b>	<b>5,109</b>	<b>62.16%</b>
Noncontrolling interests	2.1	0.02%	5.5	0.07%
<b>Total equity</b>	<b>4,482.30</b>	<b>38.92%</b>	<b>5,114.50</b>	<b>62.23%</b>
<b>TOTAL LIABILITIES AND EQUITY</b>	<b>\$11,516.70</b>	<b>100.00%</b>	<b>\$8,219.20</b>	<b>100.00%</b>

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

**i. Demonstrate that the accounting equation holds for Starbucks. Recall that the accounting equation is:  $\text{Assets} = \text{Liabilities} + \text{Equity}$ .**

Both assets and liabilities + equity are equal to \$11,516,700,000 for fiscal year 2013.

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

The major assets are PP&E and cash and cash equivalents, both at over 20 percent. Inventory is next at almost 10 percent.

Proportion of short-term assets to total assets: 47.51 percent

Proportion of long-term assets to total assets: 52.49 percent

Yes, this seems appropriate for Starbucks because PP&E would include the value of their stores as one of their largest investments, and that has the largest representation. They are close to a 1:1 ratio.

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

Intangible assets are assets not physical in nature that have a useful life greater than one year. Starbucks would likely have intangibles such as trademarks, internet domain names, and possibly trade secrets. Goodwill is an intangible asset

associated with the purchase of one company by another. It is only recorded when the purchase price of a company by another is higher than the fair value of the net assets purchased in the acquisition and can include the value of a company's brand name and solid customer base/good customer or employee relations.

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

Starbucks is financed through long-term debt and common stock. The debt-to-equity ratio is 1.57, comprised of 61 percent liabilities and 39 percent equity.

**8. Refer to Starbucks' statement of earnings for fiscal 2013 (the year ended September 29, 2013) and to the common-size income statement you developed in part f, above.**

**i. Review the revenue recognition policies of Starbucks discussed in Note 1 (Summary of Significant Accounting Policies). Does Starbucks record revenue when they receive cash from their customers (cash-basis accounting) or do they follow a different rubric (for example, accrual accounting)? How does Starbucks record revenue on stored value cards (i.e., gift cards)? What challenges in measuring revenue do you observe? That is, are there any significant judgments management needs to make in recording sales revenues at Starbucks?**

Company-operated stores' revenues are recognized when payment is tendered at point of sale, which could be considered cash-basis. They record revenue on

stored value cards when the likelihood of redemption, based on historical experience, is deemed to be remote. Some challenges to revenue recognition for Starbucks would include reporting the revenues it earns from its licensed stores such as fees paid in and royalty revenues. This would take some judgment to determine when such revenues are earned and should be recognized when they are based upon a percentage of reported sales.

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

Major expenses are cost of sales including occupancy costs, store operating expenses, and litigation charges.

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

The litigation charge went from 18 percent of total revenue to zero percent of total revenue.

**iv. In fiscal 2013, Starbucks separately reported a litigation charge and included it in operating income. Why didn't the company just include this amount within the line item for general and administrative expenses? Why is it an operating expense?**

The litigation charge had to be included in operating expenses because it was only incurred in 2013. It is not a general or administrative expense because it is not a common occurrence.



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

Profitability means that a business earns a profit which is sustainable for its size and scope and can be measured not only by determining whether the company had a net income or loss but also by evaluating performance metrics such as a profitability index which takes the present value of future cash flows over the initial investment. To this end, 2012 and 2013 both earned a profit, but only in 2012 was the company profitable. In 2013 the return on equity was only 0.185 percent; the company did not even earn a penny per dollar invested. Starbucks competitors’ industry average is around 10 percent, so in 2012 the company was relatively profitable, earning a 27 percent ROE.

**9. Refer to Starbucks’ fiscal 2013 statement of cash flows.**

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

The statement of cash flows adjusts net earnings to net cash from operating activities by adding back depreciation and amortization, the litigation charge, deducting gains on sales, adding/subtracting deferred income taxes, deducting income from equity investees, adding back stock compensation, and other balance sheet adjustments.

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

The “additions to property, plant, and equipment” line item that contributes to investing activities on the statement of cash flows shows that Starbucks spent \$1,151,200,000 on PP&E during fiscal 2013.

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

Cash dividends paid during fiscal 2013 according to the statement of cash flows were \$628,900,000,000. Cash dividends declared from Retained Earnings in the statement of equity were \$668,600,000. This means that not all dividends declared were paid out during 2013.

**10. Several notes to the financial statements refer to the use of “estimates.”**

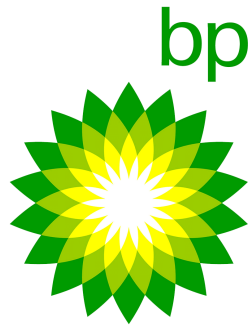
**Which accounts on Starbucks’ balance sheet require estimates? Are any accounts estimate-free?**

Affected accounts include assets, liabilities, revenues, and expenses; for example, asset and goodwill impairments, inventory reserves, income from unredeemed store value cards, stock-based compensation estimates, and future asset retirement obligations. No account on the balance sheet is truly free from estimate.

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

Signed Jordan Watts (electronic signature)

# BP Oil Spill



## Contingencies Examination

By: Jordan Watts

The University of Mississippi

## **Executive Summary**

This case provided a very comprehensive understanding of the implications of contingent liabilities on a company's financial statements. It was helpful to contrast the contingent liabilities related to the BP oil spill with contingent warranty costs in order to remember the basic rules for accounting for these liabilities in a simpler situation. The exercise was also enlightening in exposing what kinds of judgments companies and their auditors must make in reference to contingent liabilities; the Gulf oil spill is somewhat of an extreme example of how difficult these judgments can be when the economic environment in which they take place is so complex.

Perhaps the most interactive and intriguing part of this case was coercing the reader to consider exactly how to go about tallying up realistic amounts for damages. Before reading it, I would have used industry trend rates to estimate the impact of the recession in order to deduct that impact from total damages. After guidance from the case, however, I saw that they gave the Valdez oil spill in 1989 as a standard for comparison, which is a lot more helpful because at the time, BP and its auditors did not have the benefit of hindsight to see what factors were actually at play. From my analysis, I determined that by looking at trends in similar industries elsewhere in the United States and comparing their performance to that of the businesses on the Gulf, estimates can be gathered on how much of the declines were caused by the economy and seasonal fluctuations rather than the oil spill. The remaining difference should be compared to the impact of the Valdez oil spill and then adjusted on a case-by-case basis in regards to each business's likely claim to damages to determine the closest probable future legal sacrifice BP should record in its financial statements.

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

The designation of contingency means that a transaction which would materially affect the financial statements of a company has the potential to occur depending on the outcome of an uncertain future event. A contingent liability is a liability (probable future sacrifice of resources) that may or is likely to occur, but is still uncertain. A contingent liability is recorded in the financial reports if the event is deemed probable and the amount of the liability can be reasonably estimated. Some common contingent liabilities are loss from damage to property or employees, warranties, and lawsuits. Banks that issue standby letters of credit or other obligations have contingent liabilities as well as creditors in general, as they carry the possibility of not being repaid. The idea of contingent assets/gains, however, does not affect financial statements until the transaction involved has been settled.

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

### **what is a warranty?**

In this case, the product warranty is only a contingent liability from the perspective of GE because they are the ones who would have to fix or replace the equipment within the two-year period if the situation occurred. Because this is an assurance type warranty for BP on the equipment it purchased, it would include the cost of the warranty in the equipment account of the asset section of the balance sheet. Also, the liability needs to be matched to the period of the sale.

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

Management must make judgments to determine whether the contingent liability is probable, reasonably probable, or remote. They also must decide an amount which is reasonably estimable and the proper timing of the possible liability. For accrued warranty costs in particular, a company must make judgments for probability that warranty claims will be made based on prior experience and determine which costs to allocate to which periods over the life of the warranty. Claims for damages resulting from the oil spill have very different accounting implications, as they could not have been expected until the spill occurred. There was also little prior experience from which to base expected costs on, making it extremely difficult to judge whether the liability was 'reasonably

estimable.’

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

BP must estimate what actual damages other companies are legally entitled to, or what damages will probably hold up in a court of law which they will be held accountable for. This includes an estimate of the oil spill’s impact on different industries’ revenues such as fishing and tourism or direct damages to their property/assets based on prior estimates including other explaining factors such as seasonality and the economy, especially because the 2008 recession would have greatly affected typical revenues of the companies claiming damages. Furthermore, the U.S. Justice Department can sue all parties involved for violating the Clean Water Act and the Oil Pollution Act (OPA). It may be helpful to assess the impact of the Valdez oil spill to analyze which declines in revenues actually arose from the BP spill. BP must also estimate costs to pay legal teams and fees.

- ii. If you were the auditor for BP working with lawyers to come up with contingent liability accrual, how would you come up with or limit losses? Should all of the companies claiming damages be able to sue? Should BP have booked more or less in losses?**



I would start with taking a count of direct damages to property and physical assets, which are more easily determinable, then look at the way the oil spill impacted the revenues of companies claiming damages, which requires more judgment. For example, businesses in the Gulf's fishing and tourism industries suffered losses because of the spill. However, this event took place two years after the 2008 recession, meaning that companies' claims of differences in revenues could be caused by the contracting economy as well. A way to estimate how much of the declines caused by the economy rather than the oil spill would be to look at trends in similar industries elsewhere in the United States to determine what the standard decrease in revenues was for the industry nationwide, then look at the remaining difference as a reasonable claim of damages that they are responsible for. This difference should look similar (after adjusting for inflation) to the impact of the Valdez oil spill, another standard for comparison. Other complicating factors in the spill include which other parties should share in the charges. BP was the majority owner and operator of the lease, but Transocean was the rig's owner and Halliburton was involved in its operation. An extensive legal search should be conducted to prove exactly which parties held accountability for what contributing factors in the spill, and gross negligence needs to be proven on the part of any of the aforementioned parties. The claims should be examined on a case-by-case basis to determine direct damages and then probable future damages to revenues with regards to each individual business's likely legal entitlement to compensation.

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

Signed Jordan Watts (electronic signature)

# The Wendy's Company



## Equity Method Investments Analysis

By: Jordan Watts

The University of Mississippi

## **Executive Summary**

An analysis of The Wendy's Company's financial statements and notes focused on how equity method investments are accounted for and therefore their larger effect on how strategic investments can be made. In this case, Wendy's Co. entered into a 50-50 joint venture with Tim Hortons Inc. in order to open combination restaurants in Canada. It was helpful to first examine why these companies might have sought this agreement and how they are profiting separately from it. Wendy's used the equity method to account for its share in "TimWen," the joint venture, so this method and its effects on the financial statements of the parent company is explored in the case.

Possible judgements that must be made in the use of the equity method include the valuation of the investment on Wendy's financial statements. The purchase price at the time of acquisition is often more than the book value of the net assets involved in the purchase, so professionals must use judgement to determine how much to write up the fair value of the net assets as well as how much remaining goodwill to allocate out of this difference. These valuations affect mainly the balance sheet, but as periods pass, the investment begins to affect the income statement and statement of cash flows as well. This case comprehensively examines how the accounting for acquisition, incomes, dividends, and fair value/amortization adjustments under the equity method for a joint-venture investment affect the various financial statements for the Wendy's Company.

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

The primary advantages of a joint-venture agreement for any given company includes added knowledge, human capital, technology, and/or access to a specific market that a company cannot obtain as well on its own. Companies who enter into joint-venture agreements are typically seeking a common goal or targeting a common market. The joint-venture agreement can be very profitable for both parties involved because of the ability to access each others' specialized resources.

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

The equity method in accounting for investments refers to how companies should record investment transactions from holdings in other companies in which they have a significant influence. A company has significant influence in another company when it holds an interest of around twenty to fifty percent, but may or may not exert the influence depending on other factors even if this guideline is met. The investor accounts for its initial investment by debiting equity investment account and crediting cash for the payment. There is an adjusting entry at period end which debits the equity investment for any equity income as a percent (the same percent as their holdings) of the net income earned by the investee. To account for dividends received, cash is credited and the equity investment is credited for the amount

received to show the payout of dividends from the retained earnings of the company.

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

The difference between the amount paid for an equity investment and the investor's proportionate share of the book value of net assets is considered an acquisition accounting premium (AAP). At the time of acquisition, all of the assets and liabilities included in the investment must be written to fair value, so part of the AAP is allocated to write-ups for this purpose. The excess AAP that is left after write-ups is considered goodwill. For the equity method in particular, the investor takes the portion used to write the assets/liabilities up to fair value and charges it to depreciation each year, then uses its ownership percentage and multiplies it by the total to determine the value of the investment.

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

The equity method investments are included in the "Investments" account title on Wendy's consolidated balance sheet. With regards to Note 8, the respective amounts for the investments are \$91,742 for 2011 year-end and \$89,370 for 2012

year-end.

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

The amount recorded for Wendy's investment at December 30, 2012 was \$89,370 while the share of TimWen's equity was only \$35,282.50 (half of the "Partners' equity account of 70,565). As included in Note 8, the carrying value of this investment exceeded the interest in the underlying equity of the joint venture by \$54,088 as of December 30, 2012. The difference between these two amounts is accounted for in the acquisition accounting premium (AAP) which includes both write-ups to fair value for the investment's assets and liabilities and excess goodwill.

- 6. Consider the information disclosed in Note 8 regarding Wendy's investment in the TimWen Joint Venture.**
- i. How did Wendy's equity method investment in TimWen affect their earnings before taxes in 2012 and 2011? Where does this appear in Wendy's consolidated statements of operations?**

Equity in earnings (before taxes) for 2011 and 2012 respectively were \$10,571 and \$10,551. This equity in earnings is included in the "Other operating expense, net" in Wendy's consolidated statements of operations (income statement). Utilizing the equity method, their share of income was adjusted for excess amortization from the

acquisition price.

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

Equity Investments	13,680	
	Equity Income	13,680

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

The amortization of purchase price adjustments (PPAs) totaled \$3,129 in 2012; these are amortizations of PPAs which had a useful life of 21 years. The journal entry for amortization in 2012 would be as follows:

Equity Income	3,129	
	Equity Investments	3,129

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

Wendy's received \$14,942 and \$15,274 in dividends from the TimWen joint-venture agreement in 2011 and 2012, respectively. The journal entry for 2012 would be as follows:

Cash	15,274	
------	--------	--



Equity Investments                      15,274

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

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

An \$8,724 negative adjustment to net income from cash must be made because the company includes investment income in the income statement in total net income while the investment income has no effect on the cash balance. When the earnings were realized, they were included in net income, but the transaction was non-cash. Therefore, investment income of \$8,724 must be subtracted out of net income to reconcile it to the cash balance.

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

A positive adjustment of \$15,274 for “Distributions received from joint venture” is made in 2012 to account for the dividends that have no effect on net income but increased the cash balance. This increase reconciles the Net Income amount to the cash amount to arrive at net cash from operating activities.

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

Signed Jordan Watts (electronic signature)

Johnson & Johnson



Retirement Obligations Examination

By: Jordan Watts

The University of Mississippi

## **Executive Summary**

Johnson & Johnson's financial statements and notes on their retirement and benefits was eye-opening for a number of reasons. Throughout the case, it was easy to track the accounting process for pensions through examining the company's reports. By first distinguishing between the two types of pension plans, the reader is able to see the benefits and drawbacks to each and visualize how each plan would affect a company's financial reporting. The case then asks the reader to think conceptually about a pension obligation, examining why it is classified as a liability and predicting what kinds of changes in estimate may occur within this kind of entity. After developing a deeper understanding of the entity to be accounted for, the case guided the reader's thoughts through the technical aspects of accounting for pensions like how to arrive at pension expense and what items go into both the benefit obligation and the plan assets.

Transitioning into Johnson & Johnson's specific financial statements, it was interesting to see actual amounts that a company of its scope deals with regarding retirement funds. It was especially enlightening to learn where the plan assets are invested and to investigate why the company would invest the majority of these in equity securities. Drawing the case together, the reader is able to examine a typical amount of underfunding for a retirement plan like Johnson & Johnson's and consider the implications of that reported amount.

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

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

In a defined contribution plan, an employer agrees to contribute a predetermined amount to a pension trust each period based on a formula. The employer simply turns over an amount of pension expense each period to a third-party trustee which assumes ownership of the pension. A defined benefit plan like the one in this case that Johnson & Johnson are working with states the benefits that employees will receive when they retire and the employer must determine how to meet the benefit contribution by that time. In this type of pension plan, the employer remains in legal possession of the trust assets and liabilities and retains responsibility for the payment of benefits regardless of what happens in the trust (see flow chart).

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

A liability is defined as the future sacrifices of economic benefits that an entity is obliged to make as a result of past transactions. A retirement plan obligation meets all of these qualifications. It is a future sacrifice of money that it has legally agreed to make which results from a past transaction, namely an employee completing services for which the company must pay.



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

To account for retirement plan obligations, actuaries must make assumptions regarding what benefits should be allocated to which periods based on how long an employee will work for a company, when they will retire, and how many years the pension will have to pay between retirement and death.

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

Service cost is the actuarial present value of the benefits attributable to the pension trust resulting from an employee's service during a period. Interest is also accrued on the obligation because the company is deferring paying the liability until maturity but accounting for the service cost at a discounted rate, so the interest for the period must be added to the obligation. The rate to determine interest cost should reflect the rate at which the company can settle its pension benefits; this settlement rate is multiplied by the pension obligation's fair value at the beginning of the period to calculate interest cost. Actuarial gains and losses are due to changes in assumptions

made by actuaries that affect the amount of the projected benefit obligation and are accounted for in Other Comprehensive Income for the period, combining the net effect of gains and losses over the years in the Accumulated Other Comprehensive Income account. Benefits paid are the actual cash amounts paid to retirees out of the pension trust.

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

The actual return on plan assets is the increase in pension funds from interest, dividends, and changes in the fair value of the plan assets. Company contributions are the simple cash amounts paid to the fund by the employer. Benefits paid to retirees are the actual cash amounts distributed to the retirees out of the pension trust.

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

The "return on plan assets" in pension expense is the expected amount of return which is deducted from pension expense because it actually lowers the amount of benefit needed to be contributed by the company. Pension expense uses the expected return to reduce market-induced volatility. Expected return is calculated with a given rate multiplied by the beginning balance of plan assets. This estimate is used to

calculate pension expense so that it can be allocated throughout the year, but the actual return is calculated to be capitalized under plan assets. The “return on plan assets” included in the plan assets is the actual increase in pension funds from interest, dividends, and changes in the fair value of the plan assets known at the end of the year.

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

The retirement plan benefits are primarily based on employee compensation for the last three to five years before retirement, taking into account how many years of service the employee spent with the company. The company does not fund retiree health care benefits, so retirement plans are based on future estimates, while other benefit plans are based on current employee information.

**6. Consider Johnson & Johnson’s pension expense detailed on page 61 of the company’s annual report. Note that the company uses the term “net periodic benefit cost” to refer to pension expense.**

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

\$646,000,000



**ii. Prepare the journal entry to record the service cost and interest cost portion of the 2007 pension expense. (Journal entry in millions)**

(Service cost: \$597,000,000 + interest cost: \$656,000,000)

Pension expense	1,253	
		Projected Benefit Obligation
		1,253

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

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

The company's retirement plan obligation at December 31, 2007 was \$12,002,000,000. This value represents the total accumulated benefits earned by employees that the company is responsible for paying in the future. This number must be estimated, however, and will normally go through some changes due to changes in plan assets and actuarial changes in opinion.

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

Pension-related interest cost for 2007 was \$656,000,000. The settlement rate, or average rate used to calculate the interest cost, was about 5.62 percent ( $656,000,000/11,660,000,000$ ) in 2007. This rate seems reasonable, if possibly a little low, because the U.S. discount rate for retirement plans was 6.5 percent, but the rate

realistically depends on what rate the individual company has the ability to settle its liabilities. The average interest rate of 5.6 percent falls within the domestic and international rates disclosed in the footnotes.

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

Benefits paid from plan assets totaled \$481,000,000 in 2007. Johnson & Johnson only pays cash for its contributions to the pension trust; because the trust is, in form, a separate entity, it pays out cash for the benefits rather than Johnson & Johnson. The benefits paid reduce both the retirement plan obligation and the retirement plan assets amounts because the benefits are paid out from the assets, and paying the retirees reduces the future obligation to these retirees as the obligations come due.

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

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

The value of the assets held by Johnson & Johnson's retirement plan is \$10,469,000,000 at December 31, 2007. This value is determined by all of the company's contributions and returns (increases) on the assets in the trust, as well as participant contributions and acquisitions. Deducted from the plan assets are items

such as settlements, benefits paid, and the effect of exchange rates.

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

Expected return on plan assets was \$809,000,000 in 2007 and \$701,000,000 for 2006. Actual returns for 2007 and 2006 were \$743,000,000 and \$966,000,000, respectively. These differences are significant; that is why these gains/losses are included in Other Comprehensive Income. In my opinion, actual return better reflects the economics of the company's pension expense because it more accurately reflects the pension plan's total accumulated assets, which would in turn determine how much more the company is obligated to pay toward the trust.

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

Company contributions in 2007 were \$317,000,000 and participant contributions were \$62,000,000, so total contributions were \$379,000,000. In 2006, total contributions were \$306,000,000, which is lower but reflects the lower amount of service cost and other costs accumulated throughout the years.

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

For retirement plans, the major percentage of Johnson & Johnson's plan assets are invested in equity securities, with about 20 percent in debt securities.

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

The retirement plan was under-funded by \$1,533,000,000 at December 31, 2007, and by \$2,122,000,000 at December 31, 2006. This appears under noncurrent liabilities under the "Employee related obligations" account.

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

Signed Jordan Watts (electronic signature)

# Balance Sheet-Based Financial Reporting

The Debate on Financial Reporting Models

By: Jordan Watts

The University of Mississippi

## Executive Summary

CEASA's article "On the Balance Sheet-Based Model of Financial Reporting" strives to prove that the balance sheet orientation of accounting standard-setting is flawed, citing his five major grievances with this conceptual framework. He discusses the Financial and International Accounting Standards Boards' (FASB and IASB) goal to converge standards in order to attain uniformity and comparability and how both boards are re-considering their conceptual frameworks in the hope that a compromise can be met, though admits that a re-consideration of the balance sheet orientation is not part of this plan. CEASA then provides a brief note on the history of the balance sheet orientation versus the income statement approach and the FASB in general, concluding that the balance sheet orientation has become more popular than its counterpart in recent history because of FASB's decision that earnings is a "change in value" concept and is therefore impossible to define without first defining the "value." The history continues by walking through some of the changes FASB adopted in accordance with the balance sheet orientation approach all the way up to the 2006 preliminary views which delineated the Board' decision to address individual inconsistencies, noting some substantial changes to implement, within FASB and IASB rather than consider a different conceptual framework.

The next portion of CEASA's article critiques the balance sheet-based model of financial reporting. Conceptually, his discrepancy is that the primary mission of the firm is to earn money not by acquiring, storing, and growing assets but by sacrificing assets to produce earnings. In practice, financial statements based on the balance sheet model do not give any information as to business model or means of value creation. CEASA then

addresses the dilemmas that the FASB faced when initially deciding whether to choose a balance sheet or income statement model debunking them one by one and arguing that the concept of income is more fundamental and clear than asset valuation. Another concern he voices is that the balance sheet-based model may be encouraging a decrease in the forward-looking usefulness of earnings because simply defining earnings as “changes in net assets” implies lower persistence and predictability of earnings. Not only is the balance sheet model not leading to improved usefulness of earnings, but it also incorporates more estimates of value into financial reporting, leaving more room for error and instigating more influence from the financial market to the real business economy.

CEASA’s paper concludes that the income statement approach to accounting is the natural foundation for financial reporting and disregard for this approach inevitably leads to faulty accounting. He suggests that FASB and IASB need to make distinctions between operating and financing assets/activities and that they should emphasize the importance of matching expenses to revenues in order to foster better financial reporting.



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

When I began to read this article, I was very skeptical of the idea that the musings of one professor, regardless of the school he teaches at, could have a better grasp of what “good” accounting looks like than the entire history of collaborators of the FASB. As an accounting student who is only in her third year of undergraduate courses, every accounting standard and method I have learned has simply been whatever the FASB has declared the most accurate way to represent a business’s financials. I never thought there was anything strange about defining earnings as “changes in net assets.” I assumed that because there were so many collaborators with so much business experience working with the FASB, the current codification must be, for now, the best compromise to reflect business activity. In that sense, this article made me consider all the political and monetary factors that must go into creating accounting standards and understand that it is definitely possible that there could be a more useful and more accurately representing way to categorize and record business transactions if politics were removed from the picture.

The most interesting and thought-provoking points I read which set me on a new train of thought were the deep, conceptual ideas behind the balance sheet and income statement-based models of financial reporting. On one hand, it is true that to accurately measure a change in value is to know the beginning and end values in the first place. On the other, the idea that a balance sheet-type model puts a lot of stock into the value of physical assets that the company holds, and these assets are really only used by trading their use for something of higher value. This really does miss the value that, say, employee experience could add to a company’s intangible assets, especially in a company

that bases its business model off of consulting; furthermore, it gives no indication of what these assets are doing to earn future revenue, which is what is truly important for the economy to run and the business to be profitable for investors.

The most alarming point from CEASA's article was the indication that leaning on the balance sheet method for financial statements allows a lot of influence from the financial market into how a company is valued, therefore allowing the financial market to dictate what happens in the real economy. This is risky because market prices are really just predictions of future earnings subject to human error. This argument against the balance sheet-based model of forming financial statement regulations and the basic concept of businesses' purpose to deteriorate assets rather than warehouse them really made me consider that CEASA's grievances are valid and deserve further exploration. I would, however, like to see actual statistics rather than just conjectures on how these regulations affect the productivity of business and investments in the financial market. If these two items' qualities can be proven to have declined due to the balance sheet concept over the income statement approach, there could be a very serious debate on whether to try to solve the issues in quality of financial reporting by hammering out individual details or whether to start from the ground up with the income statement approach.

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

My first thought on how this document could affect my career was that if GAAP ever decided to change this substantially, I was certainly going to have to learn an entire new world of accounting entries and methods. Regardless of whether these particular

changes are made, this article reinforces the fact that accounting regulations, down to their very concepts, are contentious issues subject to change; I will have to be flexible in my thinking in order to adapt to the current standards that arise throughout the years. As I am taking my internship in the audit of a huge financial services market, the issue of valuing assets on the balance sheet at fair value will be something that I will have to consider every day. Anywhere in the accounting profession, however, considerations regarding the two suggestions the article makes will have to be taken into account. Every business has operating and investing activities, and in some industries it may be difficult to distinguish between the two. The article suggests listing operating and financing assets in different sections because they hold different valuation implications. This statement has merit; if a company is almost certain it is holding an asset for use for its entire life, there is no reason to make changes to its fair value based on the market rate because the only reason for the asset is to obtain revenues; therefore the amount to obtain the asset needs to be matched as an expense to these revenues. To change an asset held for use's value would ignore the key going concern accounting principle which assumes that the company will not be liquidated anytime soon- this would be the only reason a company would need to know the true market value of the asset before its possible sale when it has been fully utilized.

As a prospective public accountant, these topics of discussion are concerning because it is our responsibility to catch fraud in companies' financial statements; should our regulations allow less-than-accurate reporting, it will result in more fraud and negatively impact the world's perspective of the work that accountants do. The statistic about the volatility of reported earnings doubling over the last 40 years while their

persistence went down by a third may have other causes, but it does not look promising for the balance sheet model; the impact of this method as opposed to others on companies' tendencies toward persistent earnings could affect the whole trajectory of the U.S. economy. These arguments that poor quality earnings are resulting from the balance sheet-based model of financial reporting should be quantitatively researched and not taken lightly to ensure that the field of accounting does not belie its purpose.

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

Signed Jordan Watts (electronic signature)

Google Inc.



Earnings Announcements and Information Environment Analysis

By: Jordan Watts

The University of Mississippi

## Executive Summary

Examining the differences between stock price and actual earnings is a vital part of understanding public accounting because these companies are constantly pressured to meet or beat the earnings measures that the stock market arbitrarily places on them.

Google, in particular, faces enormous pressure as one of the most recognized company names in the world. Another task this case challenged was the examination of non-GAAP performance measures and what items were taken out of net income given the choice of the company. One interesting adjustment that Google made for the quarter ended December 31, 2013, was the elimination of a net loss from discontinued operations. This is a very small loss, but the fact that they saw fit to remove it from the bottom line seems hard to reconcile with the fact that in 2013 its GAAP financial statements reported a \$706 gain in income from discontinued operations for the year. We went on to learn that this gain stemmed from Google's sale of their unprofitable Motorola smartphone unit to Lenovo, which seemed detrimental to the company, as Google's advertisements were to be less compatible with the ever-increasing use of internet on smartphones. Google must have reversed fears in their January 30 press release, however, because out of their dip in stock price rose a temporary spike after fears were assuaged that consumers were still utilizing Google on their smartphones.

It was interesting to take a closer look at the nuances behind both the earnings that a company is reporting and the stock exchange's predictions juxtaposed for comparison. I learned just how influential the Wall Street Journal can be on fluctuating stock prices and how quickly the market adjusts to these sudden, maybe less accurate changes. I enjoyed

getting to conceptualize the dips and peaks in a whole-year stretch of measuring one company's financials, especially in hindsight.

**1. Read the excerpts of the press release titled “Google Announces Fourth Quarter and Fiscal Year 2013 Results” and review Google’s operating performance reported in the statements of income accompanying the press release.**

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

The adjustments to actual GAAP net income to get the non-GAAP results included eliminating stock-based compensation expense, restructuring and related charges, income tax effects related to both of these, and a net loss from discontinued operations. I do not agree completely with the adjustments made, though I understand how they could be informative in addition to the GAAP reported measures. I do not agree with the adjustments because they are difficult to compare to other companies' figures and therefore have little relevance in most contexts. Furthermore, stock compensation expense is recurring and also an operating expense, but it is excluded, which is inconsistent. I do respect the FASB's allowance for these non-GAAP performance measures, as it is proven that quality of earnings has improved since the regulation was issued, but I still do not believe that the companies use it for anything



except to improve their bottom line; this is evident in the fact that every one of the adjustments was erasing an expense.

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

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

Google’s earnings are much more unpredictable than its stock price projects. The company had earning spikes in late April, July, and especially in late October (around the times to file quarterly earnings). The spike in late April correlated to a dip in stock price, however, but the other two spikes do correlate to peaks. The stock price dramatically increased after the October spike even though the remainder of the year’s earnings were relatively low and marginal leading into 2014.

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

Google’s stock price rarely dipped below that of the general NASDAQ index. The price fluctuated closer to the average from January to October, but skyrocketed in November and remained far above the index leading into 2014.

**iii. Based on the stock market chart, did the market perceive the earnings news in Google’s press release dated January 30, 2014, as “good news” or “bad**

**news”? *Note:* the press release was made available after the close of trading for the day.**

The market perceived the earnings news in Google’s January 2014 press release as good news; right around the fourth quarter earnings report time there is a very irregular spike which does not plateau at all, but drops immediately back down. This illustrates that a lot of people wanted to buy it as soon as they caught wind that it may be profitable, but in reality the earnings were only steadily increasing (though reported earnings for January 30 were much higher than the average January/February reported earnings) only to decrease again in early February.

**3. Read the *Wall Street Journal* article from January 30, 2014 titled “Google Reports Higher Profit.”**

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

The article begins with “investors seem happy,” citing only positive news on Google’s earnings. It continues to talk about the company’s “strong revenue growth” and how “shares have risen about 60 percent since the beginning of 2013, including late Thursday trading.” This does not exactly match up with the real picture, as earlier in January Google’s stock price took a significant dip.

Following the press release, there was indeed a sharp increase in stock price, but it

peaked and fell immediately, lasting no longer than a few days.

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

Investors may have previously been concerned that Google was forced to sell its unprofitable smartphone unit, especially since consumers knew that internet usage was shifting to mobile devices rather than desktop computers. However, the article alleviates these concerns, saying that the rise in stock price “demonstrates that most investors are sanguine about the shift to mobile, despite the fact that Google's link-based ads don't always translate well to smaller smartphone screens.” This confirmation that consumers are indeed still utilizing Google despite prior issues with its compatibility with smartphones is likely to have contributed to the market's positive reaction.

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

Signed Jordan Watts (electronic signature)