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A COMPREHENSIVE ANALYSIS OF CONCEPTS AND METHODOLOGIES IN  
PUBLIC ACCOUNTING

by  
Lauren N. Eickholz

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  
May 2020

Approved by

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Advisor: Dr. Victoria Dickinson, PhD, CPA

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## ABSTRACT

### LAUREN NICOLE EICKHOLZ: A COMPREHENSIVE ANALYSIS OF CONCEPTS AND METHODOLOGIES IN PUBLIC ACCOUNTING (Under the direction of Victoria Dickinson)

The following thesis is comprised of twelve case studies pertaining to various accounting concepts and methodologies that are currently impacting the public accounting industry. In conjunction with the topics learned in financial accounting courses, the cases focus on various individual areas of financial reporting, often through application to specific companies and real-world situations. In addition, two individual cases evaluate specific career paths in the public accounting industry, focusing specifically on the campus recruiting process and evaluating potential cities to complete internships and start a full-time career. Combined, these cases display a comprehensive understanding of accounting principles, financial statement preparation and analysis, and applications to a future career in the public accounting industry.

These cases were completed throughout the 2018-2019 school year in ACCY 420, an accounting research course led by Dr. Victoria Dickinson. These cases were individually reviewed, evaluated, and analyzed through group discussion during the course. This thesis has been defended through participation in case competitions held by various public accounting firms.

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**Case Study 1: Data Analytics and IBM Watson**

**September 5<sup>th</sup>, 2018**

## **Executive Summary**

The research topic of this case is centered around various data analytics software tools and their significance in today's accounting industry, where technological advancements are at the forefront of industry practice. Data analytics, described as "the process of gathering and analyzing data and then using the results to make better decisions," has grown tremendously in the accounting field within the past decade, especially with the ever-increasing capabilities the various analytics platforms have to offer (Bauer). When used by accountants, data analytics tools allow for the configuration of unstructured data into systematic groups, making various accounting measures and analyses easier to conduct than ever before. Research conducted in this study focuses on a specific tool, IBM Watson, and includes the history of the tool, what it's primarily used for, cost, system requirements, and benefits related to accounting fields, specifically auditing and tax.

Data analytics knowledge and experience is a growing demand for accounting firms when hiring recent graduates. In a study conducted by Robert Half, 61 percent of firms stated that proficiency in data analytics is mandatory for potential employees (Tschakert). Conducting the research needed for this study allowed for me to immerse myself in the field of data analytics, to achieve a firm grasp on both the pros and cons of these new tools that are surfacing on the market, and to understand how they are quickly becoming the core of today's accounting firm operations. Additionally, with a base knowledge of data analytics, many firms will be willing to invest in my professional development and enhance my knowledge and understanding in the field, as nearly 90 percent of firms currently offer in-house training for analytics (Tschakert). Given the fact

that data analytics is growing exponentially in today's accounting industry, a general knowledge of these various programs will give me a leg up in the industry and allow for my professional growth alongside a potential future firm as the data analytics field continues to evolve.

## **I. The Purpose of Watson**

IBM Watson was originally created with the goal of being the first ever artificial intelligence contestant to beat a human competitor on the game show "Jeopardy!", which it achieved in 2011. The tool's main purpose centers around its human language processing ability, which allows for Watson to accumulate data from thousands of documents in plain language and sort it into structured data clusters within very small amounts of time (Shacklett). It can process and respond to questions posed by humans, using its mass data collections, which infinitely grows due to Watson's ability to teach itself and improve its own ability through the input of new information (Lohr). In the business world, this tool allows for professionals to forgo tedious data entry responsibilities and spend more time analyzing and interpreting the data to make various decisions. Additionally, this tool has previously found solutions beyond what human intelligence could identify, as demonstrated in a study conducted at the University of North Carolina School of Medicine. In this study, Watson was used in 1,000 cases involving cancer patients, and recommended treatments that doctors had previously overlooked in 30 percent of the cases (Lohr). Given this history, it can be assumed that Watson has the same ability to find revolutionary solutions when applied to business problems and situations. KPMG has already signed a contract with IBM for the Watson



tool, and its capabilities are currently augmenting employees in their decision-making in a variety of service areas (“Expanded Alliance...”).

## **II. Using Watson in Auditing and Tax Planning**

The auditing services that many firms provide include sifting through years of financial statements to identify potential threats and risks, inform clients of changing regulatory requirements, advise on both the maintenance and growth of business operations, and other services unique to each client and their individual needs.

Many big corporations that employ auditing services from outside firms expect for their financial status to be monitored routinely to ensure a high level of protection and risk management. With Watson, firms that provide auditing services would be able to offer around-the-clock monitoring, with Watson observing a client on a continuous basis, constantly scanning their financial reports, accounts, and competitive environment, among other factors. With Watson’s ability to both absorb new information and use that information to continually improve its operations, firms would be able to offer top of the line auditing services to their clients and guarantee that they are receiving the most thorough protection and risk management.

Watson could also benefit the company’s financial outlook, as corporations are always looking to for ways to increase net income and profit margin. Watson could have profound impacts on operational audits, as it would allow for quick and complete searches in the market for cheaper raw materials, solutions to create a more efficient manufacturing system, or recommendations for lower overhead expenses. As previously mentioned, Watson has recommended solutions overlooked by human intelligence before, and this capability is likely to be applicable to this scenario as well, which would

improve the firm's financial state and make it more attractive to investors, creditors, and other interested parties.

Auditing includes the verification of financial reporting standards, often by sampling various pieces of financial statements provided by a company. With Watson, an auditing firm would be able to fully absorb years of financial statement data from a client, and not only confirm the accuracy of the data but use it to create relevant trend analyses, comparative charts, and even highlight important similarities and abnormalities within the data for audit advisors to carefully examine and use as basis for recommendations to their clients, beyond just ensuring their compliance with GAAP.

Tax services provided by firms such as the Big Four are used by businesses of all sizes to assist in the understanding, interpretation, and application of tax rules and regulations. By augmenting these services with tools like Watson, it becomes easier to collect data related to tax planning and regulation and apply relevant information to clients with various needs.

One way that Watson could assist companies in providing tax services is through the determination of tax relief eligibility. Tax relief provides corporations with reduced tax liability for a variety of reasons, such as research and development expenses, foreign operations, and sustainability efforts. With the application of Watson, a firm would be able to identify and research each of these tax relief programs, as it scans data and information at an extremely rapid rate when compared to that of human ability. Through its search, Watson would be able to investigate every tax relief program both internally and abroad, determine the minimum requirements for eligibility, and recommend these programs to various clients based on their specific industries, daily operations, and

unique needs. This would benefit firms by contributing to their overall profitability through a reduced tax burden.

Watson would also be able to assist firms in advising clients on tax law changes. As laws related to tax are amended at the national level, there are substantial amounts of legislation written regularly, and firms need to stay up to date on these reforms in order to recommend the best procedure and solution to their clients. For example, the push for individual and business tax reform in a bill labeled H.R. 1 spans over 400 pages and includes 275 amendments (“H.R. 1...”). With Watson, the sizable amount of information introduced within this bill becomes completely and easily read, understood, and interpreted, leaving the determination and application of its rules and requirements up to tax advisors.

Today’s corporations are constantly evolving, and substantial financial events such as mergers and international acquisitions are becoming far less rare than they were in the past. Watson would allow tax firms to absorb the abundant tax law related to these specific financial events and determine the specific implications and impacts that companies could face when contemplating a merger or overseas growth. Its knowledge of tax law would allow for tax firms to ensure that their client’s actions fully comply with all regulations. Additionally, Watson could find the best solution or recommendation that should be made to a company given their specific situation, and as previously referenced, the solution could potentially be one previously overlooked by a firm’s professionals.

**III. A Memorandum to My Future Firm Partner on Why We Should Invest in  
Watson**

**Memorandum**

**TO: Firm Partner**

**FROM: Lauren Eickholz**

**DATE: August 31, 2018**

**SUBJECT: IBM Watson**

**I have recently conducted in-depth research into IBM's data analytics processor, Watson, and feel that we should strongly consider bridging this system with our current operations. This processor tool has the ability to greatly enhance our operations within both tax and audit and will allow us to service our clients quicker and with better solutions to increasingly complex problems.**

**The implementation of Watson would allow for our staff to spend less time examining the abundance of company data that we receive daily and more time making predictive environmental analyses, risk prevention and control, and creating innovative solutions to our client's problems and circumstances. There are no changes needed to be made to our current system to accommodate Watson, as it can absorb and interpret all types of unstructured data. It will augment, not replace, our tax and audit specialists and allow for them to spend more time exercising their expertise.**

**Although Watson is a not an inexpensive investment, we can obtain the program through the company's cloud offering, which allows for a month-to-month payment schedule, giving us freedom to cancel anytime and avoiding costly opt-out fees involved with a contract (which many other programs require), if the benefits of Watson do not outweigh the costs.**

**Let's schedule a meeting soon to further discuss the benefits of bringing on IBM Watson, which I believe would give us a significant competitive advantage and allow us to provide our clients with unparalleled service.**

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**Case 2: Rocky Mountain Chocolate Factory**

**September 11<sup>th</sup>, 2018**

## **Executive Summary**

In this case, we analyzed the financial statement reporting cycle using Rocky Mountain Chocolate Factory. Given basic financial data and a series of transactions from the period, we started by creating the necessary journal entries and adjustments, proceeded to make the necessary closing entries, and were able to create a full and complete Income Statement and Balance Sheet. The advanced functions of Excel allowed for direct links between data, simplifying the entry process and serving as a way to self-check the accounting procedures used. Through this case study, I was able to sharpen my Excel skills, especially as they relate to the accounting industry and preparation of financial statements. I am confident that this will help my future career tremendously, as many of today's professionals use Excel and similar software on a daily basis.

**I What accounts do you expect to see on Rocky Mountain Chocolate Factory's financial statements? Which accounts constitute the major assets and liabilities?**

Given the fact that this company is in the business of manufacturing chocolate, I would expect to find various Inventory accounts to represent their raw materials, work-in-process, and finished-goods inventories. I would also expect to find cash, accounts receivable, and other asset accounts that accumulate due to the sale of the manufactured chocolate. A major asset will most likely include the equipment used in the manufacturing process along with its accumulated depreciation. A major liability will most likely include wages payable, due to the large number of people most likely employed by Rocky Mountain in its various branches.

**II List at least three adjustments or reclassifications that might need to be made prior to preparing the financial statements.**

One adjustment that will have to preparing the final financial statements is to account for the depreciation for the property and equipment purchased during the period. Additionally, there needs to be an adjustment for the deferred income, as some of the franchise services will be performed over the period. Finally, the inventory account balance will need to be adjusted for the amount of inventory that was produced but not sold during the period.



**Figure 1: Rocky Mountain Chocolate Factory Journal**

	Beginning Balance (February 28, 2009)	1	2	3	4	5	6	7	8	9	10	11
Cash and cash equivalents	1,253,947			17,000,000	(8,200,000)	4,100,000	(2,000,000)	(6,423,789)	125,000	(498,832)	(2,403,458)	790,224
Accounts Receivable	4,229,733			5,000,000		(4,100,000)						(702,207)
Notes Receivable, current	-											91,059
Inventories	4,064,611	7,500,000	6,000,000	(14,000,000)								(66,328)
Deferred Income Taxes	369,197											92,052
Other (current)	224,378											(4,215)
Property and Equipment, Net	5,253,598								498,832			132,859
Notes Receivable, less current portion	124,452											139,198
Goodwill, net	1,046,944											
Intangible assets, net	183,135											(73,110)
Other (non-current)	91,057											(3,007)
Accounts Payable	1,074,643	7,500,000			(8,200,000)							503,189
Accrued salaries and wages	423,789		6,000,000					(6,423,789)				
Other accrued expenses	531,941						3,300,000					(2,885,413)
Dividends Payable	598,986									3,709		(1)
Deferred income	142,000								125,000			(46,062)
Deferred income taxes	827,700											66,729
Common stock	179,696											1,112
Additional paid-in capital	7,311,280											315,322
Retained Earnings	5,751,017										(2,407,167)	
Sales				22,000,000								944,017
Franchise and Royalty fees												5,492,531
Cost of sales				14,000,000								693,786
Franchise costs												1,499,477
Sales and Marketing							1,505,431					
General and administrative							2,044,569					(261,622)
Retail operating							1,750,000					
Depreciation and amortization												
interest income												(27,210)
Income Tax Expense												2,090,468

	Unadjusted Trial Balance	12	13	14	15	Pre-Closing Trial Balance	Closing Entries	Post-Closing Trial Balance	Actual February 28, 2010 F/S Figures
Cash and cash equivalents	3,743,092					3,743,092		3,743,092	3,743,092
Accounts Receivable	4,427,526					4,427,526		4,427,526	4,427,526
Notes Receivable, current	91,059					91,059		91,059	91,059
Inventories	3,498,283	(216,836)				3,281,447		3,281,447	3,281,447
Deferred Income Taxes	461,249					461,249		461,249	461,249
Other (current)	220,163					220,163		220,163	220,163
Property and Equipment, Net	5,885,289		(698,580)			5,186,709		5,186,709	5,186,709
Notes Receivable, less current portion	263,650					263,650		263,650	263,650
Goodwill, net	1,046,944					1,046,944		1,046,944	1,046,944
Intangible assets, net	110,025					110,025		110,025	110,025
Other (non-current)	88,050					88,050		88,050	88,050
Accounts Payable	877,832					877,832		877,832	877,832
Accrued salaries and wages	-			646,156		646,156		646,156	646,156
Other accrued expenses	946,528					946,528		946,528	946,528
Dividends Payable	602,694					602,694		602,694	602,694
Deferred income	220,938					220,938		220,938	220,938
Deferred income taxes	894,429					894,429		894,429	894,429
Common stock	180,808					180,808		180,808	180,808
Additional paid-in capital	7,626,602					7,626,602		7,626,602	7,626,602
Retained Earnings	3,343,850					3,343,850	3,580,077	6,923,927	6,923,927
Sales	22,944,017					22,944,017	(22,944,017)	-	22,944,017
Franchise and Royalty fees	5,492,531					5,492,531	(5,492,531)	-	5,492,531
Cost of sales	14,693,786	216,836				14,910,622	(14,910,622)	-	14,910,622
Franchise costs	1,499,477					1,499,477	(1,499,477)	-	1,499,477
Sales and Marketing	1,505,431					1,505,431	(1,505,431)	-	1,505,431
General and administrative	1,782,947			639,200		2,422,147	(2,422,147)	-	2,422,147
Retail operating	1,750,000			6,956		1,756,956	(1,756,956)	-	1,756,956
Depreciation and amortization	-		698,580			698,580	(698,580)	-	698,580
interest income	(27,210)					(27,210)	27,210	-	(27,210)
Income Tax Expense	2,090,468					2,090,468	(2,090,468)	-	2,090,468

**Figure 2: Rocky Mountain Chocolate Factory Income Statement**

<b>Rocky Mountain Chocolate Factory</b>	
<b>Income Statement</b>	
<b>For the Period Ended February 28, 2010</b>	
<b>Revenues</b>	
Sales	22,944,017
Franchise and royalty fees	<u>5,492,531</u>
<b>Total Revenues</b>	<u><b>28,436,548</b></u>
<b>Costs and Expenses</b>	
Cost of sales	14,910,622
Franchise costs	1,499,477
Sales and Marketing	1,505,431
General and administrative	2,422,147
Retail operating	1,756,956
Depreciation and amortization	<u>698,580</u>
<b>Total Cost and Expenses</b>	<u><b>22,793,213</b></u>
<b>Operating Income</b>	<u><b>5,643,335</b></u>
<b>Other Income (Expense)</b>	
Interest Expense	-
interest income	27,210
Other, net	27,210
Income Before Income Taxes	5,670,545
Income Tax Expense	<u>2,090,468</u>
<b>Net Income</b>	<u><u><b>3,580,077</b></u></u>
Basic Earning Per Common Share	0.60
Diluted Earnings Per Common Share	0.58

Figure 3: Rocky Mountain Chocolate Factory Balance Sheet

**Rocky Mountain Chocolate Factory**  
 Balance Sheet  
 As of February 28, 2010

Assets	
<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 (current)	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 (non-current)	88,050
<b>Total Other Assets</b>	<b>1,508,669</b>
<b>Total Assets</b>	<b>18,919,914</b>
Liabilities and Stockholder's Equity	
<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>
Deferred income taxes	894,429
<b>Commitments and Contingencies</b>	
<b>Stockholder's Equity:</b>	
Preferred Stock, \$.10 par value, 250,000 authorized; 0 shares issued and outstanding	-
Series A Junior Participating Preferred Stock, authorized 50,000 shares	-
Undesignated Series, authorized 200,000 shares	-
Common stock	180,808
Additional paid-in capital	7,626,602
Retained Earnings	6,923,927
<b>Total Stockholder's Equity</b>	<b>14,731,337</b>
<b>Total Liabilities and Stockholder's Equity</b>	<b>18,919,914</b>

**Figure 4: Rocky Mountain Chocolate Factory Cash Flows**

<b>Transaction</b>	<b>Statement of Cash Flows Section</b>
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

**Case Study 3: Common Recruiting and Internship Misconceptions**

**September 18<sup>th</sup>, 2018**

## **Executive Summary**

This case presented us with three distinct scenarios, all of which were related to the process of accounting firms recruiting students for both internships and ultimately permanent careers. At the Patterson School of Accountancy, this recruiting process often takes place during the span of a student's junior year, where the student is invited to various socials and events put on by public accounting firms in an effort for both parties to acquaint themselves with one another, in hopes of finding a good fit for employment. Once a student chooses a firm, city, and accounting field they are interested in, the goal is to obtain an internship offer from the firm, which will take place during the spring semester of the student's senior year. Depending on the student's level of performance and overall fit in the firm's work environment, they could potentially be presented with a job offer from that firm, contingent upon graduation and CPA certification. As one quickly realizes, this entire process is built on the foundation of the decision a student makes during their junior year of college, often without complete certainty in their choice, oblivion to the severity of the decision, or without guidance from an experienced and knowledgeable mentor. It then becomes the case that the student accepts an offer without realizing the 'strings attached', so to speak, and could default on their commitment, either intentionally or not.

Throughout the research and discussion attached to this case, I learned that while we as students have many expectations of the firms vying for our employment, they have many expectations for us as well. My eyes were opened to the lengthy and rather expensive measures these firms put forth during the recruitment process through socials and lavish events, and how their investment into recruitment is a gamble in hopes that

they will receive a return on their investment in the form of top-notch and long-term talent. As I embark on the recruiting process, I have a new perspective: the decisions I make should not be taken lightly, as the commitment at the end of the road holds high expectations for my performance and will permanently affect my long-term career path.

Given this new perspective, I also learned that transparency is imperative throughout the recruiting process. If I have plans other than to accept a job offer from a firm after an internship, then I need to communicate those plans upfront to the recruiter, and accept the fact that the process may not go as smoothly with long-term career goals that stray away from the public accounting sector.

#### **I. Scenario One: Law School**

In this scenario, a student majoring in accounting is discussing his plans to go through the recruiting process, go on an internship during the spring semester of his senior year, and then proceed to attend law school upon graduation. He remains on the public accounting career track in hopes that an internship with a large firm will sharpen his resume and boost his chances of getting into a good law program to study tax law.

In theory, this plan is acceptable and probably encouraged by some professors, advisors, and law school recruiters. By majoring in accounting, the student will have in-depth knowledge of tax policies, procedures, and applications that will prepare him tremendously in the pursuit of a tax law specialty. In addition, through an internship, assuming he accepts an offer to practice tax, he will gain hands-on experience in a corporate environment and can apply classroom knowledge while also expanding upon his knowledge of tax practice. As he embarks on a tax law specialty, this internship will have numerous benefits beyond just enhancing his resume. Furthermore, with the

University of Mississippi Law School and Master of Tax joint program, the student could receive both degrees in just three years, maximizing his career opportunities and limiting the amount of tuition involved.

On the other hand, by pursuing an internship and not conveying his law school plans to the firm or recruiter, he is allowing the firm to rely on the assumption that he intends to be a long-term employee of their company. The generous amounts of time and money spent recruiting him are not just to secure his talent for a six-week internship, but to eventually bring him on board as a permanent employee. By completing an internship and foregoing a full-time offer, he is wasting the firm's resources, allowing the recruiter to be responsible to the firm for a faulty hire, and potentially preventing the firm from recruiting at the University of Mississippi in the future if other campuses provide more committed candidates.

If the student had communicated his tax law plans up-front to the recruiters, this would have been a respectable and ethical course of action. The firms would then be allowed to decide if they wanted to continue to recruit this student; if the student is a top performer, it is likely that he would still receive an offer, as many firms recognize talent and are willing to take a gamble on that student's commitment to the company.

## **II. Scenario Two: Investment Banking and/or Consulting**

In this scenario, Jamie is an accounting major but has found that she does not enjoy the practice and no longer plans to pursue a career in the public accounting sector, but rather in the field of investment banking or consulting. She feels that these careers will earn her a higher income than a career in public accounting, and that accounting experience will look better on an application for an MBA program. However, she still



plans to go through the recruiting process and pursue an internship with a public accounting firm.

This scenario is very similar to the last in that there is nothing inherently wrong about this position. Many will say that if the student truly does not enjoy accounting, she should remove herself while she still can and pursue other career options. However, it is smart and forward-thinking to remain an accounting major, as accounting is commonly referred to as the ‘language of business’, and with a degree in accounting you can land an impressive position in almost any field. Additionally, many advisors and professors will encourage a student to pursue a degree from the Patterson School of Accountancy as the school’s top national rank holds more weight on the job market.

However, as the previous scenario proved, this path requires transparency to recruiters during the internship recruiting process. If one truly does not plan to pursue a career in the public accounting sector, this needs to be communicated in advance to firms so they have full knowledge of the situation before choosing to recruit you with substantial resources. Additionally, it should be noted that when firms come to recruit at universities such as Ole Miss, they have a finite number of internship spots to offer to students. As many professionals both inside and outside of the public accounting sector will note, it is extremely difficult for a candidate to obtain a position at a national public accounting firm without previous internship experience. Therefore, by a student taking an internship position without plans of accepting a full-time position, they could potentially be taking the spot of another candidate who has goals of receiving an internship offer in hopes of being able to gain access to a career in public accounting.

Again, the unethical side of this situation could be alleviated by honesty and transparency from the student up-front. Many of the firms that recruit for audit and tax practices also have consulting and advisory practices and would be happy to work with you to find a way to experience different fields during an internship. With this opportunity, a student would be able to use real-world experience as the basis for a career path decision.

### **III. Scenario Three: Internship Offer Transfer**

In the final scenario, a student has accepted an internship offer and spent six weeks in Washington D.C. at a firm. However, upon returning to the University to complete the academic requirements necessary for full-time employment, the student has reached out to a former professor inquiring on the correct procedure for transferring a job offer to his home city of Dallas.

In this situation, it is easy to sympathize with the student, as it is difficult to ask college students where they want to spend the next three to five years of their career. The student envisioned Washington D.C. as a fresh, lively experience, but soon came to realize that it was not what he was hoping for and now feels his career is better suited back home in Dallas. The student even has plans to stay with the same firm, and many firms are flexible and willing to work with an intern or employee's desires and career goals. Everyone makes errors in judgement, and this student is just wanting the ability to make an adjustment in their long-term career path.

However, this request is not as small as it may seem. First, the student should be in contact with the firm's recruiter and should be expressing these concerns and desires with him or her as soon as they arise. By waiting until after the internship and going

through a former professor first, the student is only minimizing the chances of a transfer to another city by delaying the process. Additionally, the decision of moving from Washington D.C. to Dallas was made after spending a mere six weeks at the D.C. office, which is a negligible amount of time when making a decision of this magnitude. It would be in the best interest of the student to not jump to conclusions and spend a few years as a full-time employee in the city before requesting a transfer. This not only allows more time to make a permanent decision, but also gives the student the opportunity to show the firm he is a top performer, and therefore could earn the ability to transfer based on priority. If at the end of this process he is still committed to working in Dallas, the student needs to understand that he is basically re-entering the recruiting process and is vying for a spot in the Dallas office against many other candidates, and it may take some time for a vacancy to open.

Although seemingly insignificant, the transfer from one city to another puts a considerable burden on the original city from which the student accepted an internship offer. First, that office is the one that fronted the resources and took a risk by recruiting the student, with the underlying assumption that he would be a long-term asset for that specific office. Additionally, for future recruiting purposes, that office may choose to no longer recruit on the University of Mississippi campus, as students may prove to be a higher recruiting risk than students of other campuses. When accepting an internship offer, students need to keep these facts in mind and understand that an internship offer is intended to be a long-term commitment.

**Case 4: Generic Bank—Accounting for Debt Securities Sales and Impairments**

**October 2<sup>nd</sup>, 2018**

## **Executive Summary**

This case involves Generic Bank, a large, well-established regional bank, whose CFO wants to free up cash to increase the financial flexibility of the bank and allow for the payment of end of year bonuses. In order to achieve this, the CFO is considering the sale of seven of the bank's debt securities, most of which have a fair market value below the acquisition price. By analyzing the factors presented in the case regarding the securities, the task is to determine if the securities are impaired. Both the seven securities that were sold and the remaining securities in the bank's portfolio must be considered. The point of view on impairment recognition of different professionals, including an external auditor and a bank regulator, are analyzed as well.

By researching the various financial accounting standards that cover debt securities and impairment losses, I learned a vast amount on a topic I was previously unfamiliar with. Many of the standards researched and included in this case are still being amended today, and the effects of these amendments have not yet been implemented as official generally accepted accounting principles. After examining these standards and applying them to Generic Bank in the various scenarios, I feel confident that I have a general knowledge of a current topic that is directly affecting today's accountants, and I now am able to watch these standards evolve in real time. In order to complete the requirements of this case I had to actively sift through and identify applicable information in the FASB Codification, which was my first encounter with the system. Although I was overwhelmed at first, I have now developed the capabilities needed to effectively use the system, which will be an imperative skill as I complete accounting coursework and as I move into a professional career in the industry.

**I. Does the bank have an impairment loss in 20x2?**

Generic Bank does have an impairment loss in 20x2. Although the fair-value losses reported for the available-for-sale debt securities are not credit-related (per the assumed assertion on page four of the case), the bank is required to prove they had intent to hold the securities until recovery to avoid impairment. They cannot reasonably prove this intent due to the fact that Winters considered the sale of seven debt securities for liquidation purposes in 20x2, and proceeded to sell the securities in 20x3 (ASC 326-30).

Winters first considered the sale of these securities in 20x2 in order to pay employee bonuses, among other reasons. Therefore, under ASC 320-10-35-33, because the initial intent occurred in 20x2, the bank should recognize the impairment loss in 20x2, even though the official decision to sell the securities was not made until the following fiscal period.

An impairment loss is recognized when actual cost is greater than the current fair value cost. It should be noted that when examining the securities on an individual basis, the securities with CUI SP numbers ending in 67 and 96 are not recognized as having an impairment because the fair value of the securities has not declined, but rather increased due to reasons not specifically given (ASC 326).

**II. Does the bank have an impairment loss on other securities?**

The bank does not have an impairment loss on other securities because they do not intend to sell securities other than the seven sold in 20x3. According to ASC 320-10-50-6, information such as the financial position of the securities should be disclosed with financial statements, however, the impairment loss does not need to be

recognized until there is an intent to sell the securities. One could argue that the bank's intent to hold the securities is questionable, as they have already sold seven in the early stages of the financial period. However, the case provides evidence to support that there are other means of liquidation available to the bank, so it could be reasonably assumed that there is an equal chance that they could capitalize on another opportunity

**III. If you assume the position of the external auditor, does your answer change?**

**What about the role of bank regulator?**

Assuming the position of the external auditor, the answer could potentially change. As stated earlier, there is an assertion on page two of the case that allowed for the assumption that no credit losses in the bank's securities exist. However, as the external auditor, it is expected that there would be reason to investigate this claim. If the changes in fair value are found to be due to credit losses, then all securities that have experienced a decline in fair value are impaired and the firm must recognize the impairments in value equal to that of the loss and record the loss in other comprehensive income (ASC 326-30). This would change the previous answer to part two of the case, which held the position that there is not enough evidence to support the recognition of an impairment loss on the remaining securities in the portfolio. It does not, however, change the answer to question one of the case, as the bank would still recognize an impairment loss on the seven securities sold in 20x3.

If the position of the bank regulator is assumed, the answer does not change.

According to the Federal Reserve issuance SR 96-32, member banks must comply with GAAP, including FAS 115, which outlines the requirements for the accounting

of impairment losses. As a regulator, one would hold the position that an impairment loss has occurred on the seven securities sold in 20x3, and an impairment loss on the remaining securities is dependent upon the bank's intent to hold the securities until recovery.

**IV. How would your answer of questions one and two change if the securities sold had a collective net gain? What if all the securities sold were in gain positions?**

In order for an impairment loss to be recognized, the fair value must be less than the historical cost of the securities (ASC 326). If the securities sold had a collective gain, then only the securities with a fair value less than acquisition cost would be recognized as having an impairment loss. The collective net gain would be recognized on Generic Bank's income statement at the end of the reporting period in which they were sold, which occurred in 20x3. It should still be taken into consideration whether the bank intends to hold the other securities until recovery when determining if an impairment loss occurred among the securities not sold in 20x3.

If all seven of the debt securities sold were in a gain position, then there would be no need to consider impairment for those securities. However, you would still need to consider recognizing an impairment loss on the other securities in the portfolio if deemed necessary after consideration of the previously stated factors.

**V. Assume Generic bank does sell the securities in 20x3 but is adequately capitalized rather than well capitalized, and other liquidity routes are more limited. Does Generic Bank have an impairment loss on the other securities?**



Given the changes in the bank's asset and liquidity availability, it is reasonable to assume that there is a probable chance the bank is considering the sale of the remaining securities. As noted in section two of the case, the previous circumstances allowed for the assumption that the bank had no intent to sell the remaining securities because they had the opportunity to capitalize on the other means of liquidation. Now that this assumption can no longer be made, there is not enough evidence provided to prove that the bank has the intent to hold the securities until the fair value recovers, as the bank needs money to honor debt obligations and wants to improve capital ratios. Per ASC 320-10-50-6, because the bank is considering selling the securities, an impairment losses must be recognized for the debt securities in Generic Bank's portfolio that have a fair value lower than historical cost.

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**Case 5: Future Career Cities- Nashville, TN and Louisville, KY**

**November 7<sup>th</sup>, 2018**

## **Executive Summary**

The purpose of this case was to analyze two cities that are of interest for our future internship and career. Within our analysis of these cities, we looked at several important considerations including crime rates, tax levels, transportation systems, and approximate housing rates. This case allowed for me to take a deeper look into the cities of Nashville, TN and Louisville, KY, beyond that which I have experienced as a frequent visitor. I chose to research these two cities for a number of reasons. First, I have always loved Nashville and Louisville and all that they have to offer in terms of entertainment, restaurants, and other great experiences. Both cities are very close to my hometown of Paducah, KY, making trips home to see my family and friends a very easy road trip.

At first, I was very hesitant about the research required to complete this case, as I thought I knew everything about these cities from my numerous visits all throughout childhood and now into my adult years. However, this case seemed to prove how much I didn't know, especially when it comes to important factors such as crime rates and income taxes. After completing this case, I will be making a much more educated decision when it comes time to choose the city I want to intern and eventually work in for the first several years of my professional career.

After researching both cities, I have determined that I ultimately want to pursue a career in Nashville, TN. Although both cities are very similar in terms of size and location, I feel that Nashville has favorable characteristics that will better fit my career and lifestyle in the long run, such as low tax rates, less crime, and more overall growth and prosperity. Although Louisville is not currently the best fit for me, I could see myself eventually moving to the city later down the road if the opportunity presented itself.

## **PART ONE: NASHVILLE**

### **I. Population**

According to 2010 Census, population of the Davidson County-Nashville area was 601,222, and it was estimated to be 667,560 in 2016. Many think the population of Nashville is growing rapidly, however, according to a recent article from the Tennessean, growth of the city's population is beginning to decrease for the first time since 2011.

### **II. Climate**

The climate of Nashville is considered to be very similar to that which we experience here in Oxford, MS-- a mild experience of all four seasons, with temperatures not reaching extreme levels, and only an occasional winter that includes snow or other extreme elements. However, just as any other city, Nashville does have its fair share of rare weather events-- such as a 70 degree January day in 2000 and 14 tornados in one day in February 2008, and the record rainfall in 2010 that led to a deadly flood and caused nearly \$120 million in public infrastructure damage. However, these instances are all extremely rare and will not play into my decision when choosing Nashville as a future place to live.

### **III. Topography and Scenery**

The city sits on the Cumberland River, allowing the downtown area (including the Nissan Stadium and the Riverfront concert area) to have a beautiful view of the boats and other river traffic. The elevation is 550 feet at the lowest point and 1,100 feet at the highest point of the city, which is known as the rim around the Nashville basin. As you drive into Nashville, you see beautiful mountain ranges that surround the city. The appendix includes a picture of the skyline of the city.

#### **IV. Tax Rates**

The sales tax in Nashville is 9.25 percent. I would not be paying any property taxes during my first few years of residence, as I would likely be renting an apartment near the downtown area for ease of commute. In the appendix, there is a table that gives a breakdown of the state, local, and federal income taxes and their effect on an income around \$50,000

#### **V. Transportation**

Nashville has its own international airport, Nashville International Airport (BNA), which services all of the main airlines and now offers direct flights to many international locations including London. Additionally, there are extensive interstate routes that connect Nashville with several other cities including Louisville, Indianapolis, Chicago, Atlanta, Little Rock, Oklahoma City, and Memphis. These routes are ideal for work-related travel, as many of the firm's Nashville offices are small and often assist in other cities in addition to the regular in-office demands. The city also has a bus-system, taxi services, a commuter rail, and both Uber and Lyft.

#### **VI. Prevalent Industries**

The appendix includes a breakdown of Nashville's top industries, with the biggest being healthcare (24.1 percent), professional services (13 percent), and arts and entertainment (12.1 percent). There are six Fortune 500 companies headquartered in Nashville, including HCA Holdings, Community Health Systems, Dollar General Corp., Tractor Supply Co., LifePoint Health, and Delek US Holdings, which collectively generated over \$100 billion in revenue in 2016. Other major companies with headquarters in Nashville

include Back Yard Burgers, Bridgestone, Cracker Barrel (CBRL Group), and the Country Music Association.

## **VII. Healthcare**

With Nashville being a healthcare mecca, the quality of care is considerably higher than that of comparable cities. The city has several nationally ranked hospitals, including the Vanderbilt University Medical Center (nationally ranked in Specialties and Children's Specialties), St. Thomas West Hospital, and the TriStar Centennial Medical Center.

## **VIII. Crime**

Common types of crime include larceny-theft (over 19,000 cases reported in 2017) and assault (5,072 cases reported in 2017). U.S. News gave Nashville a 6.3/10 crime index score, indicating high crime rates based on the national average but lower crime rates than similar metropolitan areas including Charlotte, NC and Portland, OR. Appendix includes a graph depicting Nashville's crime rate over the past several years compared to the national average; although it is considerably higher than average, it has been on a steady decline. Despite these crime rates, Nashville was still named the #11 best city to live in and #7 best place to retire to.

## **IX. Rent and Housing**

Because I would be a young professional living in Nashville, I would prefer to live in an area that is centrally located to both my job and several entertainment venues, such as Lower Broadway, Nissan Stadium, Bridgestone Arena, etc. as well as shopping malls and centers. Ideally, I would like to live in either the Gulch or West End. Depending on the neighborhood, I would likely pay anywhere from \$800-\$1200 in rent per month, but with full amenities included. These estimates are based on having a roommate, which I prefer

over living alone. Additionally, a roommate in Nashville would be very easy to find as several Ole Miss graduates move to Nashville each year. I have included in the appendix a sample property from each of these neighborhoods for reference.

#### **X. Commute**

The typical mode of commuting for Nashville professionals is driving your personal car, or walking, depending on location. Based on the locations I previously listed, I would likely drive my car to work each day. According to the most recent census, the mean commute time for workers over the age of 16 was 24.2 minutes.

#### **XI. Grocery Shopping**

There are many grocery stores in each of these areas, including your basic Wal-Mart and Kroger and specialty stores such as Trader Joes and Whole Foods. I would frequent all of these options depending on my varying needs and frequency of cooking vs. eating out, depending on my workload, among other factors.

#### **XII. Laundry**

Each apartment listed includes a washer and dryer, so I would do my laundry in the comfort of my apartment.

#### **XIII. Involvement**

Three philanthropic initiatives I would like to be involved with include the Girl Scouts of America, Kappa Delta Alumnae Association of Nashville, and Ethos Church

#### **XIV. Activities**

Many consider Nashville to be the country music capital of the world and refer to the town as “Music City”. Nashville earned this name from the number of entertainment events and activities that occur in Nashville on a daily basis. The city has several concert



locations including Bridgestone Arena, The Grand Ole Opry, the Ryman Auditorium, and the Ascend Amphitheater, among smaller venues. Each year the city hosts the Country Music Association (CMA) Fest, which is a four-day festival in downtown Nashville featuring hundreds of country music artists playing at a variety of venues. One can get the full country music experience through the CMA Awards, which are hosted every year at Bridgestone Arena to recognize the top country music artists.

Nashville also has a great variety of sports entertainment, including the Tennessee Titans NFL Team who plays in the Nissan Stadium in downtown Nashville, the Predators NHL team that plays in Bridgestone Arena, a minor-league baseball team known as the Nashville Sounds, and the Vanderbilt Commodores, an D1 NCAA school who plays other Southeastern Conference competitors (including Ole Miss) in Nashville.

#### **XV. Travel Home**

Nashville is very close to my hometown of Paducah, KY. The two cities are directly connected by I-24, which allows for an easy 137-mile drive which takes an average of two hours. This is the main way to travel between the two cities, although one could also take an Uber, Lyft, or taxi at a premium price if circumstances require. The average cost of making the drive would be about the cost of a tank of gas, which averages anywhere from \$35-\$40 in my car depending on gas prices.

## **PART TWO: LOUISVILLE**

### **I. Population**

According to recent census estimates, the population of Louisville is 616,261, making it the largest city in the state of Kentucky.

### **II. Climate**

Louisville's climate is very reflective of the climate that the rest of the state experiences, therefore I am very familiar with the seasonal fluctuations. Typically, one will experience average winters and summers, with a fluctuating rainfall that averages around 45 inches per year. Some winters will experience several snowy days, while others will only get a minimal dusting. Although the winters are a slight bit colder than that which we experience in Oxford, the weather as a whole would not be that big of an adjustment if I chose to pursue a career in Louisville.

### **III. Topography and Scenery**

Louisville is very much a city, with a prosperous downtown area full of high-rise office spaces and other commercial structures. However, there are also several historic districts right outside of the city's center that offer a lot of charm and home-like feel. The city sits right on the Ohio River, which provides a beautiful view and also water-related activities, such as boating or skiing. In the appendix, you will find a picture of the skyline view of the city.

### **IV. Taxes**

The Kentucky sales tax is 6 percent. Because I would be renting a property for the first several years, I will likely not be paying any property taxes. The appendix includes a

breakdown of each of the Federal, State, Local, and FICA tax rates, and how they would affect a salary of \$50,000/year.

## **V. Transportation**

Louisville offers a variety of transportation options including an extensive bus route operated by the Transit Authority of River City and domestic and international flights at the Louisville International Airport. However, the primary mode of transportation is driving personal cars, which would be my preferable method of getting around as a member of the Louisville community. Additionally, Louisville ranked 43rd in most walkable cities in a recent study, so location-permitting, I might be able to walk to work which would not only save money but would also allow me to get my exercise in during busy season.

## **VI. Prevalent Industries**

The primary industry around Louisville is intertwined with transportation and logistics. Similar to Memphis's relationship with FedEx, Louisville has a major UPS hub that is highly vested in the community and not only provides several jobs but also affects many other sectors, such as public accounting.

## **VII. Healthcare**

For normal adults, healthcare in Louisville is similar to what one would find in an average Metropolitan area. However, for children and women receive top-notch levels of care through the University of Louisville School of Medicine which is consistently ranked in the upper half of medical school equivalents. A recent study conducted by the Leapfrog Group this past year gave the Women and Children's hospital an A in overall healthcare.

## **VIII. Crime**

Louisville's crime rate is almost 5 times higher than that of the rest of the state of Kentucky. 1 in 136 people living in the city are likely to become a victim of violent crime. Statistics show that Louisville is safer than only 5 percent of cities in the US. The more dangerous areas of the city encompass the downtown area, as is the case with most metropolitan cities. The appendix includes a crime map that indicates by dark blue color the most dangerous areas of the city.

## **IX. Rent and Housing**

The rent in Louisville is lower than that of other cities I have pursued as a potential career location. The city has thousands of historic, charming homes, many of which are available to rent for very low prices. I would most definitely be able to find nice, spacious living areas for under a thousand dollars living in Louisville. The appendix features two viable properties in preferred neighbors, Bardstown Rd. and the Highlands, both of which are very centrally located in comparison to the downtown area.

## **X. Commuting**

As previously mentioned, a vast majority of people living in Louisville drive their personal car to work. The average Louisville commute time is around 23.7 minutes; therefore, I would leave at minimum 30 minutes before work from either location to ensure I made it on time.

## **XI. Grocery Shopping**

The founder of Kroger is from Louisville, so the Kroger shopping centers in the area are very nice, with overflowing sections of organic options, fresh fruits, and other great availability. It is likely that I would do my grocery shopping at one of these stores,

although the city also has other options for groceries including Trader Joes and Whole Foods.

## **XII. Laundry**

Both of my property options have washer and dryers in the unit, so I would be able to do my laundry at home.

## **XIII. Involvement**

Potential organizations I could pursue involvement in include Southeast Christian Church, Louisville Young Professionals, and the Kappa Delta Chapter at the University of Louisville

## **XIV. Activities**

Some activities that I would personally be interested in including boating on the Ohio River, University of Louisville and University of Kentucky Athletics, The Kentucky State Fair, and the two-week Kentucky Derby celebrations along with other races at Churchill Downs. Additionally, the city offers The Louisville Zoo, Kentucky Science Center and Louisville Slugger Museum.

## **XV. Travel Home**

The mode of travel would be by car. It is approximately a 3-hour drive from my hometown. Depending on gas fluctuation, currently it would cost about \$58 in my car to go roundtrip.

**Appendix 1- City of Nashville, TN Skyline View**

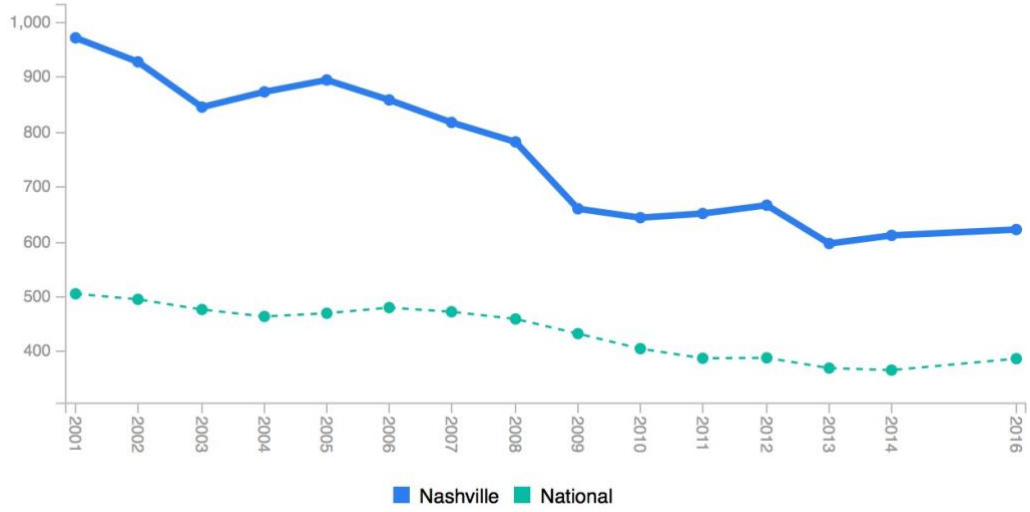


## Appendix 2- Personal Taxes for Nashville, TN

Tax Type	<u>Marginal Tax Rate</u>	<u>Effective Tax Rate</u>	2017 Taxes
Federal	25.00%	13.56%	\$8,139
<u>FICA</u>	7.65%	7.65%	\$4,590
State	0.00%	0.00%	\$0
Local	0.00%	0.00%	\$0
<b>Total Income Taxes</b>			<b>\$12,729</b>
<b>Income After Taxes</b>			<b>\$47,271</b>

### Appendix 3- Nashville Crime Rates from 2001-2016

Violent Crime Rate Over Time



Data sourced from the Federal Bureau of Investigation's Uniform Crime Report.



## Appendix 4– Apartment option for the Gulch neighborhood in Nashville, TN

### The Residences at Capitol View

Rent: \$2320 per month; \$1,160 per bed

Square footage: 1128 sq. ft.

Number of Roommates: 1

Amenities:

- Unit: Sun deck with view of the Capitol, keyless fob entry to units, floor to ceiling windows, farm style sink, quartz countertops
- Community: salt-water pool, full-sized volleyball court, wood outdoor yoga deck, gas grill stations, music room, controlled access, reserved parking spaces



## Appendix 5– Apartment option for the West End neighborhood in Nashville, TN

### The Duet Apartments

Rent: \$1,970 per month; \$985 per bed

Square footage: 991 sq. ft.

Number of Roommates: 1

Amenities:

- Unit: stainless steel appliances, hardwood cabinets and floors, personal balcony, granite countertops
- Community: adjacent to Centennial Park, pool, billiards and entertainment room, business center, controlled access, 24/7 fitness center, rooftop courtyard, parking garage with reserved spots



## Appendix 6- Nashville Budget

### Monthly Budget for Nashville, TN

#### % of Income Spent



69%

#### Summary

Total Monthly Income  
**\$5,000**  
Total Monthly Expenses  
**\$3,445**  
Total Monthly Savings  
**\$1,555**

#### Monthly Income

Item	Amount
Accounting Firm Salary	\$5,000.00

#### Monthly Expenses

Item	Amount
Rent	\$1,000.00
Taxes	\$200.00
Cell phone	\$45.00
Groceries	\$500.00
Gas for Car	\$150.00
Credit cards	\$500.00
Auto insurance	\$50.00
Miscellaneous	\$1,000.00

<b>Monthly Savings</b>	<b>\$1,555.00</b>
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## Appendix 7- Louisville Budget

### Monthly Budget for Louisville, KY

#### % of Income Spent



81%

#### Summary

Total Monthly Income  
**\$5,000**  
Total Monthly Expenses  
**\$4,045**  
Total Monthly Savings  
**\$955**

#### Monthly Income

Item	Amount
Accounting Firm Salary	\$5,000.00

#### Monthly Expenses

Item	Amount
Rent	\$800.00
Taxes	\$1,000.00
Cell phone	\$45.00
Groceries	\$500.00
Gas for Car	\$150.00
Credit cards	\$500.00
Auto insurance	\$50.00
Miscellaneous	\$1,000.00

**Monthly Savings** \$955.00

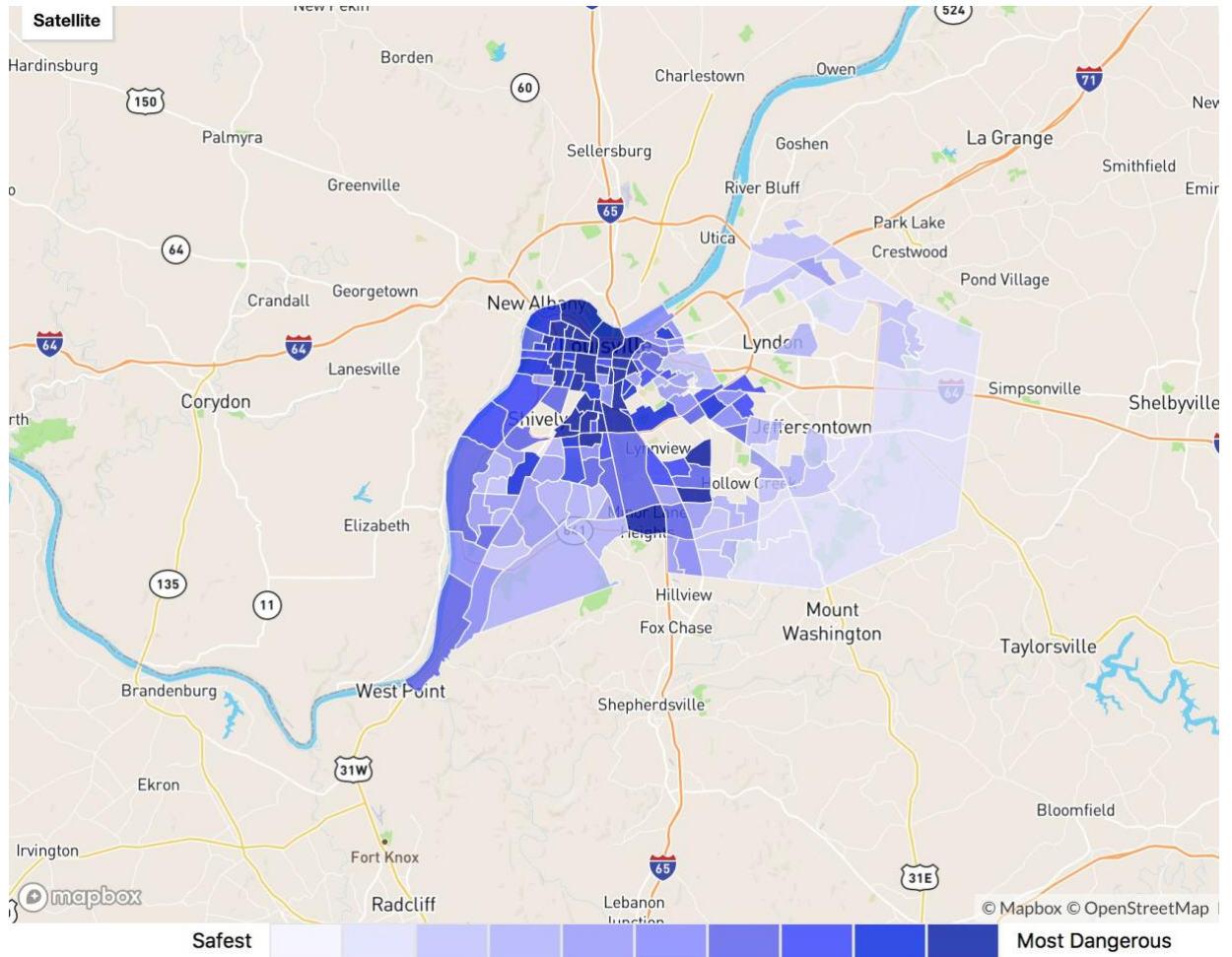
**Appendix 8- City of Louisville Skyline View**



### Appendix 9- Personal Taxes for Louisville, KY

Tax Type	Marginal Tax Rate	Effective Tax Rate	2017 Taxes	2018 Trump Taxes*
Federal	25.00%	11.28%	\$5,639	\$4,370
FICA	7.65%	7.65%	\$3,825	\$3,825
State	5.80%	5.14%	\$2,572	\$2,373
Local	2.20%	2.20%	\$1,100	\$1,100
<b>Total Income Taxes</b>			<b>\$13,135</b>	<b>\$11,668</b>
<b>Income After Taxes</b>			<b>\$36,865</b>	<b>\$38,333</b>

## Appendix 10- Crime Map for Louisville, KY



## Appendix 11– Apartment option for Louisville, KY

Bardstown Road

Rent: \$899 per month

Square footage: 725 sq. ft.

Number of Roommates: None

Amenities:

- Unit: stainless steel appliances, hardwood cabinets and floors, personal balcony, granite countertops
- Community: large-sized community pool, upscale neighborhood, ample parking





## Appendix 12– Apartment option for Louisville, KY

### The Highlands Area

Rent: \$1549 per month; \$775 per bed

Square footage: 990 sq. ft.

Number of Roommates: 1

Amenities:

- Unit: granite countertops, easy to clean carpet, new A/C units, walk-in closets, washer and dryer
- Community: large-sized community pool, newly constructed, walking distance from downtown, on-site parking



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**Case 6: WorldCom, Inc.**

**November 15<sup>th</sup>, 2018**

## **Executive Summary**

In this case, we examined WorldCom, Inc., a telecommunications company that is widely known for the fraud committed by a controller under the direction of the company's CEO in 2001. The decision was made to record fraudulent accounting entries so the company could meet their earnings per share predictions made by financial analysts in 2001. This decision ultimately led to the demise of the telecommunications giant, jail time for the company's executives, and increased financial reporting regulations that remain in effect today. In this case, we analyzed the exact accounting entries that were made in 2001, the entries that should have been made, and the difference in the company's financial statements under the two scenarios.

I learned a variety of different things relevant to my future career in public accounting through the study of WorldCom in this case. For one, I gained experience related to analyzing financial statements of real companies and effectively identifying the pertinent information necessary for my analysis. More importantly, however, I learned the importance of honesty and integrity in my future career in public accounting. The actions of WorldCom's controller, Mr. Myers, may have been meaningless and insignificant at the time, but snowballed into an ethical disaster that affected the lives of thousands of WorldCom employees and shareholders. This scenario has taught me that no matter the situation, unethical practices are never an option. In my future career, I will strive to not only remain honest and maintain a strong moral compass, but also to help facilitate an ethical environment in my future workplace.

**I. FASB Statement of Concepts No. 6 describes the building blocks with which financial statements are constructed.**

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

An asset is a resource secured through a previous economic exchange(s) that are currently reported on the balance sheet and have future value or benefit. An expense arises when an asset is used in an economic event that directly correlates to the fundamental business practices of the user.

**ii. When should costs be expensed and when should they be capitalized as assets?**

A cost is capitalized when it is likely that it will have financial or operational benefit to the company in the future. If it is unlikely to have affects in the future of the company, then it is expensed. The organization must also take into consideration the materiality of the cost. If it is relatively small, then it is traditionally expensed. However, this treatment lends itself to increased personal judgment and subjectivity.

**iii. What becomes of “costs” after their initial capitalization? Describe how the balance sheet and income statement are affected by a decision to capitalize a given cost.**

When costs are capitalized, they become part of the asset they are associated with. They increase the recorded book value of the asset that is shown on the balance sheet. If you were to expense the cost then it would increase the total expenses shown on the income statement which in-turn decreases net income; capitalizing a cost does not affect the income statement.

**II. In WorldCom’s statement of operations, what line costs were reported for 2001? Prepare the journal entry and describe what “line costs” are.**

The line costs reported for 2001 are \$14.739 billion. Line costs are central to the operations of WorldCom, as they represent the fees incurred for the use of networks owned by third party providers. Under FASB Statement of Concepts No. 6, these fees should be expensed. The journal entry to record the accumulation of line costs for the year is as follows (in billions):

<b>Dr:</b> Line Cost Expense	14,739
<b>Cr:</b> A/P	14,739

**III. What types of costs were improperly capitalized by WorldCom and what transactions gave rise to these costs? Do these costs meet the definition of assets in part a?**

The controllers of WorldCom were considering the line costs incurred as costs associated with the company’s equipment, therefore capitalizing the amounts. In actuality, the line costs are associated with equipment that is not part of the company’s assets, rather equipment owned by third-party broadcast companies that WorldCom pays to access. Therefore, the costs should have been expensed rather than capitalized because they did not increase the value of any of WorldCom’s assets and do not meet the definition of assets in part a.

**IV. Prepare the journal entry that records the incorrectly capitalized line costs. Where do they appear on the balance sheet and statement of cash flows?**

The line costs recorded incorrectly debit an asset account, therefore appearing on the balance sheet within the assets section. This entry allows for costs to be recorded as

Capital Expenditures within the Investing Activities section of the statement of cash flows.

The entry that incorrectly records the line costs is as follows (in billions):

<b>Dr:</b> Property, Plant, and Equipment	3,055	
	<b>Cr:</b> Line Costs (Expense)	3,055

**V. Prepare the journal entry to record the depreciation of assets in 2001.**

As noted in the case, the straight-line depreciation is taken at the midpoint of the useful life for the transmission equipment, therefore 22 years was used to calculate the depreciation for 2001. The entry for the year ended on December 31, 2001 is as follows, with calculations for the total expense broken down in the appendix (in millions):

<b>12/31/2001</b>	<b>Dr:</b> Depreciation Expense	83,307	
		<b>Cr:</b> Accumulated Depreciation	83,307

**VI. Calculate WorldCom's net income assuming correct treatment of the costs using a tax rate of 35%. Is the difference in net income material?**

With costs recorded in the proper manner, net loss totals to \$(341.150 million), which is a material difference from the amount of \$1.501 billion reported by WorldCom as net income in 2001. The calculation of net income for 2001 is included in the appendix.

### Appendix 1: Depreciation Expense Calculation Breakdown

$$\text{Q1: } \frac{\$771,000,000}{22 \text{ years}} \times (4/4) = \$ 35,045,454.55$$

$$\text{Q2: } \frac{\$610,000,000}{22 \text{ years}} \times (3/4) = \$ 20,795,454.55$$

$$\text{Q3: } \frac{\$743,000,000}{22 \text{ years}} \times (2/4) = \$ 16,886,363.64$$

$$\text{Q4: } \frac{\$931,000,000}{22 \text{ years}} \times (1/4) = \$ 10,579,545.45$$

**Total Depreciation Expense for 2001:** \$ 83,306,818.18



**Appendix 2: Consolidated Income Statement for WorldCom, 2001**

WorldCom Inc. and Subsidiaries  
Consolidated Income Statement  
For the Years Ended December 31, 2001

Income Before Income Taxes	\$ 2,393,000,000
Depreciation Expense	\$ 83,306,818.19
Improper capitalization of line expense	\$ 3,055,000,000
Loss	<u>\$ (578,693,181.81)</u>
Income Tax Expense	\$ 202,542,613.63
Minority Interest	\$ 35,000,000
<b>Net Loss</b>	<b><u><u>\$ (341,150,568.18)</u></u></b>

**Case 7: Starbucks Corporation—Understanding Financial Statements**

**March 6<sup>th</sup>, 2018**

## **Executive Summary**

This case focuses on the analyzation and interpretation of financial statements, specifically those of Starbucks Corporation in the fiscal years ending in 2012 and 2013. We started by identifying the type of business that Starbucks operates and the way in which they earn revenue, and we were able to grasp an understanding of the business and how the financial statements should reflect their operations. Creating common-sized income statements and balance sheets allowed for the comparison of individual line items to the company's net revenue and net assets, respectively. We also examined the Statement of Cash Flows and Statements of Comprehensive Income to determine the way the company is financed and the cash inflows and outflows within various activities. By selecting the year 2013, the case included the sizable lawsuit Starbucks Corporation faced in that year, which had a significant impact on earnings as discussed below.

By conducting the research and in-depth analysis needed to complete this case, I was given the opportunity to gain hands-on experience in the analyzation of financial statements. As students and accounting majors, we spend a significant amount of time in class learning about these statements and the information that goes into their formation, but we rarely get the opportunity to analyze the statements and their importance in terms of an actual, real-world public company that many of us are extremely familiar with. Some aspects of the case also required the comparison between Starbucks and other companies in terms of asset ownership, which is something I didn't have experience with but is very important, as it is the reason the IRS and SEC mandate specific reporting of financial data in the first place.

## **I. The Nature of Starbucks' Business**

Starbucks Corporation is a global chain of retail coffee shops that began with a single store in Seattle, WA. As they have expanded their locations worldwide, they have also expanded their menu offerings to include a variety of pastries, smoothies, and even pre-packaged food for on-the-go patrons. However, in 2018, beverage sales comprised the largest portion of the company's fourteen-billion-dollar revenue generated in the United States at fifty-eight percent (Statista). Starbucks is also a wholesaler, as they sell a variety of their products to grocery stores and other retail chains across the world.

## **II. Financial Statements Prepared by Starbucks**

The financial statements required by the Generally Accepted Accounting Principles (GAAP) are the Balance Sheet, Income Statement, Statement of Owner's Equity, and the Statement of Cash Flows. The Securities and Exchange Commission (SEC) ensures that all publicly traded companies, including Starbucks, prepares these financial statements each reporting period. Starbucks refers to their financial statements as Consolidated Statements of Earnings (Income Statement), Consolidated Statements of Comprehensive Income (Statement of Retained Earnings), Consolidated Balance Sheets, and Consolidated Statements of Cash Flows. The term consolidated refers to the presentation of parent and subsidiary companies' financial statements together as if the two companies were merged together as one.

## **III. Frequency and Timeliness of External Financial Statements**

The Securities and Exchange Commission requires that all publicly traded companies publish their financial statements annually via a Form 10-K. Publicly traded

companies are also responsible for submitting a Form 10-Q on a quarterly basis to provide for more frequent, on-going reporting as well as an 8-K for important financial events, such as a declaration of bankruptcy or disposition of an asset.

#### **IV. Parties Involved in Creating and Reviewing the Financial Statements**

A company's management is responsible for the composition and submission of the financial statements. If the company has an internal auditor, that person is responsible for the assurance of the completeness and accuracy of information included in the financial statements. Once published, the financial statements that Starbucks produces will likely draw the attention of investors and potential investors that are interested in the company. These parties are interested in the financial performance of the company, as well as any financial outlook they can gain from their analysis of the statements or the analysis of an external party, such as a financial analyst.

#### **V. Starbucks' External Auditors**

Starbucks has previously hired Deloitte, a worldwide public accounting firm, to audit and certify their financial statements. Within the two opinion letters written in November of 2013, the auditors on the Deloitte team explain the processes they used to audit the consolidated financial statements and internal controls of Starbucks Corporation and its subsidiaries. These letters certify the fairness, accuracy, and completeness of the financial statements as well as the efficiency of the internal controls. The standard unqualified opinion issued by Deloitte shows creditors, investors, and all other interested parties that Starbucks is conducting their operations appropriately and their financial statements can be trusted to provide accurate information. These opinions are dated significantly after the company's year in

because it takes Starbucks a sizable amount of time to gather the information and publish the financial statements, and then Deloitte goes in to conduct a lengthy audit on both the financial statements and the internal controls.

**VI. Starbucks' Income Statements and Balance Sheets for 2012-2013.**

See appendices one through four below.

**VII. Refer to Starbucks' balance sheet for the 2013 fiscal year.**

**i. Accounting Equation**

11,516.70 (assets) = 7,034.40 (liabilities) + 4,482.30 (equity)

**ii. Major Assets**

The major assets owned by Starbucks include property, plant and equipment, cash and equivalents, and inventory. Of the total amount of assets retained by Starbucks, 47.51 percent are short-term, and 52.49 percent are long-term, meaning they are held by the company for longer than one year. Dunkin (previously known as Dunkin Donuts), an industry competitor of similar size, has ratios of 14.27 percent current assets and 85.73 percent long-term assets, showing that Starbucks has a slightly more balanced portfolio.

**iii. Intangible Assets and Goodwill.**

The term intangible assets refers to any company-owned property that cannot be physically touched. This category of assets includes patents, goodwill, human intelligence, among other items. Goodwill, specifically, is generated from the purchase of another company where the purchase price exceeded the overall value of the company's assets less the liabilities. Starbucks Corporation could have ownership of intangible assets like a patent for a specific coffee roasting method

or a copyright on the brand name of one of their specific coffee offerings, such as the Pike Place Roast.

**iv. Financing**

Like many other publicly traded companies, Starbucks is financed through a combination of equity (stock) and debt (borrowing). Of their total financing of \$4.48 million, \$4.13 million comes from non-owner sources and is generated from company profits and held in retained earnings.

**VIII. Refer to Starbucks' Statement of Earnings and to the common-size income statement for 2013.**

**i. Revenue Recognition Principles**

Starbucks recognizes revenue when they receive cash from customers, net of any applicable sales or transaction taxes. Revenues generated from their licensed stores are realized on the accrual basis, while royalty revenues are estimated on a percentage basis. For revenues related to the sale of beverages and pre-packaged drinks to other retailers (i.e. grocery stores), Starbucks recognizes the income when received by the customer or distributor. Starbucks generates a significant amount of revenue through purchased and unused gift cards each year, in which revenue is recognized when the gift card is redeemed or when the estimated likelihood of redemption is considered insignificant due to inactivity. The ability to measure when exactly a store gift card is deemed "unredeemed" is difficult, and likely requires an education guess from upper management on when this date should be. It is likely that they will make it sooner rather than later, as the date of un-redemption allows them to recognize revenues and boosts their earnings.

## **ii. Major Expenses**

Cost of Sales (also known as cost of goods sold) accounted for 42.86 percent of Starbucks' net sales in 2013, while store operating expenses accounted for 28.76 percent. These two categories of expenses are significantly larger than the other line items seen in 2013 and 2012.

## **iii. Significant Changes in Cost Structure**

There is a litigation charge that accounted for 18.7 percent of the net sales in 2013, which is not reflected in 2012. It can be assumed that this charge was an unexpected expense that is not normally accounted for in yearly operations. This charge is likely a result of the legal battle between Starbucks and Kraft Foods in 2013 that resulted in a \$2.8 billion settlement.

## **iv. Separately Listed Litigation Charge**

This litigation charge was likely listed separately due to the large amount of the payment. A two-billion-dollar settlement is unlikely to go unnoticed by investors if co-mingled with other operating expenses, and Starbucks increases the transparency and understandability of their financial statements if this charge is listed separately with the appropriate line title.

## **v. Profitability**

Profitable is understood to mean any amount earned as revenue in excess of expenses, as can be seen on the company's income statement. In 2013, the company's income statement will reflect a loss before income taxes, but the net income reflects a very small profit. In 2012, however, the company earned a profit of \$1,384 million, or 13.14 percent of net assets.



**IX. Refer to Starbucks' fiscal 2013 statement of cash flows.**

**i. Starbucks' Net Earnings vs. Net Cash Provided by Operating Activities**

In 2013, the company had net earnings of \$8.8 million, with net cash provided by operating activities totaling to \$2,908.3 million. This difference is a result of the fact that net cash provided by operating activities does not take into account operations that do not involve the transfer of cash, such as depreciation expenses and asset impairments.

**ii. Cash Used for Property, Plant, and Equipment**

In 2013, Starbucks used \$1,151.2 million of investing cash flows on the purchase of property, plant, and equipment.

**iii. Dividends**

Starbucks paid 628.9 million in cash dividends in 2013. The statement of equity reflects that 419.5 million in dividends were declared in 2013.

**iv. Balance Sheet Accounts with Estimates**

The following accounts require the use of estimates: asset impairments, goodwill impairments, stock-based compensation forfeiture rates, future asset retirement obligations, inventory reserves, self-insurance reserves, income from unredeemed gift cards, and future tax consequences of present accounting events. The only account on Starbucks' balance sheet that is likely estimate-free is the cash and cash equivalents line item.

## Appendix 1- Common-Sized Income Statement for 2013

<b>Common-Sized Income Statement</b>	<b>12 Months Ended</b>
<b>In Billions, except Share data in Millions, unless otherwise specified</b>	<b>Sep. 29, 2013</b>
Company-operated stores	79.19%
Licensed stores	9.14%
CPG, foodservice and other	11.67%
Total net revenues	100.00%
Cost of sales including occupancy costs	42.86%
Store operating expenses	28.78%
Other operating expenses	3.07%
Depreciation and amortization expenses	4.17%
General and administrative expenses	6.30%
Litigation charge	18.70%
Total operating expenses	103.87%
Gain on sale of properties	0.00%
Income from equity investees	1.69%
Operating income	-2.19%
Interest income and other, net	0.83%
Interest expense	-0.19%
Earnings before income taxes	-1.54%
Income taxes	-1.60%
Net earnings including noncontrolling interests	0.06%
Net earnings attributable to noncontrolling interest	0.00%
Net earnings attributable to Starbucks	0.06%

□

## Appendix 2- Common-Sized Income Statement for 2012

<b>Common-Sized Income Statement</b>	<b>12 Months Ended</b>
<b>In Billions, except Share data in Millions, unless otherwise specified</b>	<b>Sep. 29, 2013</b>
Company-operated stores	100.00%
Licensed stores	11.49%
CPG, foodservice and other	14.76%
Total net revenues	126.25%
Cost of sales including occupancy costs	55.18%
Store operating expenses	37.19%
Other operating expenses	4.08%
Depreciation and amortization expenses	5.22%
General and administrative expenses	7.61%
Litigation charge	0.00%
Total operating expenses	109.29%
Gain on sale of properties	0.00%
Income from equity investees	2.00%
Operating income	18.96%
Interest income and other, net	0.90%
Interest expense	-0.31%
Earnings before income taxes	19.55%
Income taxes	6.40%
Net earnings including noncontrolling interests	13.14%
Net earnings attributable to noncontrolling interest	0.01%
Net earnings attributable to Starbucks	13.14%

### Appendix 3- Common-Sized Balance Sheet for 2013

<b>Consolidated Balance Sheets (USD \$)</b>	
<b>In Millions, unless otherwise specified</b>	
	<b>Sep. 29, 2013</b>
<b>Current assets:</b>	
Cash and cash equivalents	22.36%
Short-term investments	5.71%
Accounts receivable, net	4.87%
Inventories	9.65%
Prepaid expenses and other current assets	2.50%
Deferred income taxes, net	2.41%
Total current assets	47.51%
Long-term investments	0.51%
Equity and cost investments	4.31%
Property, plant and equipment, net	27.79%
Deferred income taxes, net	8.40%
Other assets	1.61%
Other intangible assets	2.39%
Goodwill	7.49%
<b>TOTAL ASSETS</b>	<b>100.00%</b>
<b>Current liabilities:</b>	
Accounts payable	4.27%
Accrued litigation charge	24.17%
Accrued liabilities	11.02%
Insurance reserves	1.55%
Deferred revenue	5.68%
Total current liabilities	46.69%
Long-term debt	11.28%
Other long-term liabilities	3.11%
Total liabilities	61.08%
<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	0.01%
Additional paid-in capital	2.45%
Retained earnings	35.86%
Accumulated other comprehensive income	0.58%
Total shareholders' equity	38.90%
Noncontrolling interests	0.02%
Total equity	38.92%
<b>TOTAL LIABILITIES AND EQUITY</b>	<b>100.00%</b>

## Appendix 4- Common-Sized Balance Sheet for 2012

<b>Consolidated Balance Sheets (USD \$)</b>	
<b>In Millions, unless otherwise specified</b>	<b>Sep. 30, 2012</b>
<b>Current assets:</b>	
Cash and cash equivalents	14.46%
Short-term investments	10.32%
Accounts receivable, net	5.91%
Inventories	15.10%
Prepaid expenses and other current assets	2.39%
Deferred income taxes, net	2.90%
Total current assets	51.09%
Long-term investments	1.41%
Equity and cost investments	5.60%
Property, plant and equipment, net	32.35%
Deferred income taxes, net	1.18%
Other assets	1.76%
Other intangible assets	1.75%
Goodwill	4.86%
<b>TOTAL ASSETS</b>	<b>100.00%</b>
<b>Current liabilities:</b>	
Accounts payable	4.84%
Accrued litigation charge	0.00%
Accrued liabilities	13.79%
Insurance reserves	2.04%
Deferred revenue	6.21%
Total current liabilities	26.89%
Long-term debt	6.69%
Other long-term liabilities	4.20%
Total liabilities	37.77%
<b>Shareholders' equity:</b>	
Common stock (\$0.001 par value) - authorized, 1,200.0 shares; issued and outstanding, 753.2 and 749.3 shares (includes 3.4 common stock units), respectively	0.01%
Additional paid-in capital	0.48%
Retained earnings	61.40%
Accumulated other comprehensive income	0.28%
Total shareholders' equity	62.16%
Noncontrolling interests	0.07%
Total equity	62.23%
<b>TOTAL LIABILITIES AND EQUITY</b>	<b>100.00%</b>

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**Case 8: BP and Related Contingencies**

**April 3<sup>rd</sup>, 2019**

## **Executive Summary**

In this case, we examined the financial statements and related notes released by BP for the 2010 reporting period. This was the fiscal year that included the 2010 Deepwater Horizon Explosion and Spill on the Gulf Coast, which was the cause of billions of dollars in damages for the company and multiple litigation suits that were ongoing for several years after the incident, some which are still being litigated today. Specifically, we examined the contingent liabilities that BP had to estimate at the time of the incident in order to ensure complete, transparent, and accurate financial statements. To determine whether BP appropriately estimated these liabilities, we broke down the concept of a contingent liability; we examined the events that create a contingent liability situation, the amount that should be reported within the financial statements or in the related notes, and the criteria that must be met for the liability to be reported. We also looked at the difference between a contingent gain and a contingent loss, as well as the different reporting approaches of each party in contingent transaction.

Through the research and financial statement analyzation required in this case, I learned that not every decision made by an audit or management team is entirely black and white. When BP approached the task of estimating the contingent liability resulting from the oil spill, their internal professionals were required to make judgement calls related to the amount of contingent liability to report, as there were several unknown factors that prevented them from having a concrete estimate of expenses from future events such as legal suits and various fines and penalties. However, I learned that an understanding of the accounting treatment stipulated by FASB for contingent gains and losses provides guidance on how to calculate and report the most educated estimate.



## **I. Contingent Liabilities**

A contingent liability is a payment or obligation arising from probable future events. Probable is defined in this context as more likely to happen than not. A company would record this liability when it is deemed likely that this future event will occur, and the dollar amount of the liability can be reasonably estimated. Examples of contingent liabilities or losses include settlements from a pending lawsuit, the expenses of an active product warranty, customer refunds or partial returns, debts that could be defaulted on, liquidated damages incurred from performance failure on a contract or other formal agreement, or government fines such as EPA violations or other civil penalties. A contingent gain, in turn, would be a payment received from another party as a result of a probable future event. Examples of a contingent gain or asset include proceeds from a pending lawsuit in which the company is likely to win or the asset changes that may result from a potential company merger or acquisition. To ensure prudent and conservative financial statements, the Financial Accounting Standards Board (FASB) has stipulated in Statement of Financial Accounting Standard No. 5, *Accounting for Contingencies*, that contingent assets should not be recorded in the financial statements, but rather disclosed in the notes to the financial statements in the reporting period in which the above criteria are met.

## **II. Product Warranties Related to the Purchase of a Telescopic Joint**

The purchaser, BP, has the opportunity to return the telescopic joint or receive repairs at limited to no cost under the two-year warranty. They do not record the warranty on their financial statements, as it is considered a contingent gain. If the amount of the repair or replacement can be reasonably estimated and it is likely that BP will take

advantage of the warranty during the two-year window, the contingent gain received from the warranty should be recorded in the notes to the financial statements. The seller, GE Oil and Gas, must take into consideration the fact that BP has the opportunity to take advantage of the warranty over the two-year period. If the amount of the warranty expense can be reasonably estimated, BP should allocate the estimated warranty expense between financial reporting periods based on the two years in which the warranty is active and record the amount as a contingent liability. The company can estimate the amount and likelihood of the warranty expenses based on previous sales to similar customers.

### **III. Management Judgements Related to Contingent Liabilities, Accrued Warranty Costs, and the Deepwater Horizon Oil Spill**

To appropriately account for contingent liabilities, management must make important judgement decisions related to the timing and the amount of the liability, as well as if the event that gives rise to the liability is probable. As previously stated, many of these judgements can be based on warranties from previous sales or from related industry comparisons. Specifically, accrued warranty costs require judgement related to the timing of the warranty and when management should expense the costs in order to appropriately match revenues with expenses.

Unlike warranty claims, claims for damages such as those resulting from the oil spill are outside the scope of the company's main operations and therefore cannot be estimated with reasonable certainty in the same manner as returns or warranty expenses. In order to estimate the amount of these claims and the likelihood that a liability will occur will likely require the assistance of the company's legal team. Any

liability incurred will be recorded as a non-operating expense in the financial statements.

#### **IV. Auditor's Estimations of Contingent Liabilities Related to the Oil Spill**

BP's oil spill in April of 2010 affected individuals and businesses in five states, including Louisiana, Mississippi, Alabama, Florida, and Texas. Industries that were affected include tourism (hotels, rental properties, restaurants, retail, and various other tourist attractions), commercial seafood, real estate in and around the coastal regions, and other local businesses who sustained losses due to the damages. Several individuals from the affected areas, including those who were working on the rig at the time of the spill, sued for personal injury and wrongful death, health risks from the gases and other harmful chemicals released into the air and water, and personal property damages. Additionally, the defendants faced claims from government and environmental protection agencies for the devastation and destruction of the wildlife, coastline, natural vegetation, and other surrounding damages. It's not up to myself or BP to decide if these parties have the right to sue in response to the damages caused by the spill, but rather up to the courts and judge system through the hearings and trials. Although it was undoubtedly difficult for the BP auditors and legal team to estimate the cost and timing of these lawsuits, they could likely reasonably estimate various aspects of the total legal costs, such as those related to the government fines and penalties. As stated in the notes to the 2010 financial statements, BP was only able to estimate the fines and penalties to be received for the Clean Water Act violations, as those fines are applied on a predictable, structured basis. The other fines and penalties were dependent upon the total volume of oil spilled, which was unknown at the time.

The company was not able to reasonably or accurately estimate the costs in relation to any future litigation claims, but did establish an escrow account of \$20 billion which they felt was a reasonable estimate of the amount needed to cover the various costs to be incurred during the years following the spill. This number was calculated using a complex formula that considered various factors such as the time value of money. I believe that given the amount of resources and research that was put into generating the escrow account balance, as well as the numerous unknown factors at the time, this estimate was reasonable. However, numbers generated today indicate that BP faced \$44 billion in pre-tax settlement costs, including a settlement of \$20 billion with the federal government which included amounts for restoration efforts.

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**Case 9: Wendy's and Accounting for Investments**

**April 10<sup>th</sup>, 2019**

## **Executive Summary**

This case centered around the financial statements for The Wendy's Company for the financial reporting periods ended 2012 and 2011, and by using the various statements as well as the related notes, we were able to identify important information related to Wendy's investment into Tim Horton's Inc. (referred to as "TimWen"). We analyzed the method that Wendy's used to account for these investments, known as the equity method, as well as the impact the investments had on each of the financial statements. In order to analyze their overall impact on Wendy's, we recreated the journal entries made for important transactions including recognition of investment earnings and dividends.

This case provided numerous learning opportunities related to both financial accounting procedures and other concepts that I was not familiar with before conducting the necessary research and evaluation for this case. I was able to explore the concept of an acquisition account premium, as well as evaluate the pros and cons of joint ventures and how to account for the transactions necessary in that form of business. However, the biggest takeaway for me was the overview of the accounting cycle, and how each journal entry made in the general ledger individually impacts the financial statements that formed at the end of the period. Additionally, I found it interesting to evaluate the ways that choosing different accounting treatments, such as the equity method for investments, can affect the financial statements. I feel that after completing this case I was able to take a step back from the specific details of financial accounting and look at the accounting cycle from a big picture point-of-view, which will help broaden my overall understanding as I embark on a career conducting financial statement analyses for companies similar to Wendy's.

## **I. Joint-Venture Agreements**

A joint venture consists of two or more companies who make an agreement to combine their business assets and resources over a specified period of time in an effort to achieve a particular goal. Additionally, the specific parties will decide the share each company has in the revenues and or losses that occur under the agreement.

A joint venture differs from a partnership because a joint venture is created for a single business transaction over a specific period of time, compared to a partnership which is a long-term agreement with no specified goal or operation (Aponte). An example of a joint venture is Google and NASA aggregating their information and resources for the purpose of creating a the geographically-based project now known as Google Earth.

Joint-venture agreements allow for companies to combine their competitive advantages and specialized resources to complete projects that they otherwise would not be able to achieve alone, or that would require significant costs to achieve alone. For example, in the NASA and Google joint venture, Google may have provided the customer base to market the service to while NASA contributed the infrastructure, tools, and capability needed to gather the information and geographic data needed to form the program. Additionally, by creating a joint venture, a company can reduce their own risks related to embarking on a new, sizable project. It also allows for a company to split and allocate the costs involved with completing the project.

## **II. Wendy's Joint Venture in TimWen.**

When a company purchases the stock of another business, it is known as an investment into that business and must be recorded on the purchaser's books as such.



There are multiple ways to account for this investment, and Wendy's has chosen to account for this investment using the equity method. In this method, the purchasers record the investment on their balance sheet at the cost of the investment, also known as what they paid to obtain the stock in the business. Then, throughout the time that the purchaser maintains ownership of the stock, they will increase the total amount of the investment by their proportional share of the business's revenue. This proportion is calculated based on the amount of stock the purchaser owns relative to the total shares outstanding. Additionally, the purchaser will decrease the amount of the investment by their proportional share in the business's dividends. When the business issues dividends, the purchaser not only decreases the amount of their investment on their books, but also recognizes the cash dividend received as a shareholder.

### **III. Acquisition Account Premiums**

When the amount paid exceeds the book value of the investment, this is known as an acquisition account premium, which is often recorded as goodwill on the financial statements. Goodwill is recorded as an intangible asset on the purchasing company's balance sheet in the amount that the purchase price exceeds the book value of the investment.

### **IV. Wendy's Equity Method Investments**

In 2011 and 2012, Wendy's recorded equity investments in the amounts of \$87,620 and \$91,819, respectively. These totals can be found by adding the carrying value of the two joint ventures in both years, as indicated in Note 8. This information can be located on the asset section of the balance sheet as a portion of the total line item titled "Investments".

**V. Wendy's investment in TimWen at December 30, 2012 vs. Wendy's 50% share of TimWen's equity at December 30, 2012.**

The excess of the 50 percent share of TimWen's equity over the total in Wendy's equity investment account is due to the acquisition account premium described in section 3-3.

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

**i. The Effect of Wendy's Equity Method Investment**

Wendy's investment in TimWen generated equity in earnings for the periods of 2012 and 2011 of \$13,680 and \$13,505, respectively. This information can be found on the Consolidated Statements of Operations in the costs and expenses section under "Other operating expense, net".

**ii. Journal Entry to Record Wendy's Share of TimWen's 2012 Earnings.**

Dr. Equity Investment	13,680
Cr. Investment Income	13,680

**iii. Amortization of the Purchase Price Adjustments in 2012**

The amortization of purchase price adjustments totaled to \$3,129 in 2012. The journal entry to record the amortization is as follows:

Dr. Amortization Expense	3,129
Cr. Equity Investment- Joint Venture, THI	3,129

**iv. Dividends Received from Venture in 2012 and 2011**

Per Note 8, Wendy's received \$15,274 in dividends for their investment in TimWen. The journal entry to record this reflects the fact that cash was received by

Wendy's and that the amount of their equity investment has decreased as TimWen's retained earnings decreased upon distribution of the dividends. The journal entry is as follows:

Dr. Cash	15,274
Cr. Equity Investment	15,274

## **VII. Statement of Cash Flows**

### **i. Negative Adjustment to Net Cash from Operating Activities.**

When recording amounts earned from the equity investment on the statement of cash flows, one must consider the fact that the amounts earned from the investment are not paid in cash. Therefore, they must be removed (subtracted) from net income in the statement of cash flows in order to properly calculate the cash flows due to operating activities. The amount of \$8,724 is calculated by subtracting the amortization of purchase price adjustments (\$3,129) from the equity in earnings for the period related to the TimWen investment (\$13,680). Wendy's also should subtract the equity in losses related to the Joint Venture in Japan (1,827) in order to find the net earnings from all investments.

### **ii. Positive Adjustment to Net Cash from Operating Activities.**

Unlike the earnings received from investments under the equity method, any distribution amounts are received in cash. This cash is not reported in Wendy's net income; therefore, it should be added as a positive adjustment in the statement of cash flows in order to calculate cash from operating activities. The amount recorded of \$15,274 is the amount of distributions Wendy's received from their investment in TimWen during 2012, as indicated in Note 8.

## Works Cited

Aponte, Armand. "What Is a Joint Venture?" *Www.nolo.com*, Nolo, 30 Oct. 2014,  
[www.nolo.com/legal-encyclopedia/what-joint-venture.html](http://www.nolo.com/legal-encyclopedia/what-joint-venture.html).

**Case 10: Johnson & Johnson—Retirement Obligations**

**April 19<sup>th</sup>, 2019**

## **Executive Summary**

This case provided a portion of Johnson & Johnson's consolidated financial statements and required an in-depth evaluation of the company's procedure for granting employee's post-retirement benefits. This evaluation began with specifying the difference between various benefit plans and determining the type of plan that Johnson & Johnson has elected to use. Further exploration of the financial statements led us to evaluate the different factors included in the calculation of pension expense, pension obligations, and pension assets, and how each factor is interrelated in the process of funding a pension plan. The case then required a specific look into Johnson & Johnson's financial statements and the current balance of the company's pension assets and pension obligations, as well as the amount of contributions made and benefits paid throughout the year.

This case on Johnson & Johnson gave me the opportunity to apply my knowledge of pension plans and pension funding to a real company and their specific financial statements. Although I have developed the book knowledge of this topic through my coursework, I feel that it's significantly easier to understand a concept such as pensions when you have the opportunity to see the way it functions within real financial statements. The idea of funding a pension plan and the relationship between employers, employees, pension assets, actuaries, etc. was not something I was very familiar with before studying the concept in class and conducting the research necessary for this case, but I now feel that I have a firm grasp on the topic and the pros and cons of our current pension system.

## **I. Retirement plans—Defined Benefit Plans vs. Defined Contribution Plans.**

Defined benefit plans and defined contribution plans differ in the formula used to calculate the monetary amount of contributions made to the fund by the employer. In a defined benefit plan, the amount of benefits an employee will receive upon retirement is specified, and the employer must ensure that they will have enough funds to pay the pension upon retirement of the employee. This type of plan places a significant amount of risk for the employer, as it is difficult to ensure that sufficient amounts of contributions are made on a regular basis. On the other hand, a defined contribution plan only specifies the amount that an employer contributes to the fund each period. This amount is calculated based on a formula that takes into account several factors including the age of the employee, the term of employment, and salary. A defined contribution plan does not guarantee the amount that will eventually be paid out to the employee. An example of this type of plan would be a 401(k) plan, which is becoming increasingly popular among employers today. According to Johnson & Johnson's financial statements and related notes, both defined benefit and defined contribution plans are used in providing retirement benefits to employees.

## **II. Retirement Plan Obligations as Liabilities.**

Retirement plan obligations are recorded as liabilities because the amount owed is not always paid in full. Each additional year that an employee works for a company, the employer incurs additional costs to be paid into the respective employee's pension plan (known as a service cost). This increases the amount of pension expense that is recorded on the employer's books. However, the employer may choose to not pay that expense in full, creating a pension liability on the financial statements for that period.

A liability is recorded anytime the amount of pension expense exceeds the amount contributed to the plan (known as the plan assets). See Appendix 1 for a flowchart of the pension funding process, which begins with the employer's contributions and shows the accumulation of contributions in the plan assets.

### **III. Accounting for Retirement Plan Obligations.**

In order to determine the amount to be regularly contributed to the plan for a defined contribution plan or the amount that an employee should receive upon retirement under a defined benefit plan, several assumptions must be made to provide a fair and equitable amount of post-retirement benefits for employees. These assumptions include length of employment and early retirement, the possibility of increased future salaries, interest and earnings rates, among others. Employers often make these assumptions under the guidance of an actuary, a professional trained to make accurate and appropriate predictions for each of these variables.

### **IV. Service Costs, Interest Costs, Actuarial Gains or Losses, and Benefits Paid to Retirees**

As stated above, service cost is the amount of benefits to be contributed to an employee's pension based on each additional year of service provided to the company. The service costs incurred each year increase the amount of projected benefit obligation.

Interest cost is the amount of interest incurred on the pension liability each year, as it is a deferred compensation and the time value of money must be taken into consideration. The interest cost is calculated by multiplying the beginning balance in the pension benefit obligation by an appropriate interest rate, known as the settlement rate. Interest



costs increase the projected benefit obligation.

Actuarial gains and losses are a result of an actuary's change in estimation. This change can be in response to any of the assumptions listed above that an actuary must make in order to properly account for a company's pension expense. An example of a change in actuarial assumptions would be a ground-breaking cure for a disease, which would allow for employees to live longer than expected. This example would create an actuarial loss, as the pension plan would need to make payments to the employee until their death, which would be longer than originally estimated. Actuarial gains decrease pension benefit obligations, while actuarial losses increase pension benefit obligations. Benefits paid to retirees are the amount of payments made from the pension fund to the retired employees each year. The payment of benefits decreases the pension obligation. The latter part of the flowchart in Appendix 1 depicts this process.

**V. Actual Return on Pension Investments, Company Contributions to the Plan, and Benefits Paid to Retirees.**

Actual return on pension investments is the return a company earns from the pension fund assets in a particular year. Because pension plan assets are usually held in some form of investment, such as stocks, bonds, or securities, these assets earn a return on investment at some identified return rate. The actual return can be calculated by taking the difference of the beginning and ending balances of the plan assets and subtracting any contributions made or benefits paid during the year. The actual return on plan assets increases the total balance in the plan assets and decreases the amount that an employer must contribute to the fund.

Company contributions to the plan represent the amount each year that a company pays

into the pension asset. The amount paid will increase the total pension assets. The flowchart in Appendix 1 depicts the process of employer contributions, which is also referred to as “funding” the pension plan.

Benefits paid to the retirees refers to the amount a retired employee receives each year from the date of retirement to the date of death. The amount received is agreed upon in the contribution plan created by the employer. This amount is either defined in total by the plan (defined-benefit plan) or a sum of the total contributions made by the employer during the time of employment (defined-contribution plan). Refer to the flowchart in Appendix 1 for a depiction of the benefits paid to retired employees, which decreases the total amount of pension assets.

#### **VI. Return on Plan Assets**

The amount of return on plan assets that is included in pension expense is an estimate of the return the company expects to receive that period. On the other hand, the actual amount of return is included in the plan assets balance. The reason for this difference is due to the fact that FASB has instituted a reporting standard allowing companies to include the expected return in the calculation of pension expense to allow for simpler calculations and avoid fluctuations in gains and losses.

#### **VII. Difference between Johnson & Johnson’s other-benefits plans and its retirement plans.**

According to the notes to the 2007 consolidated financial statements, Johnson & Johnson is not required to fund the retirement plans nor are there minimum statutory funding requirements in place that would specify the amount to be contributed to retirement plans each period. Additionally, Johnson & Johnson does not contribute to

health-care benefits in advance of retirement and reserves the right to make changes to the plans as necessary. In contrast, the other-benefits plans are funded periodically throughout an employee's term in order to comply with the plan agreement, regardless of if the plan is a defined-contribution or defined-benefit plans.

### **VIII. Pension Expense on the 2007 Income Statement**

The company reported \$646 million in total pension expense for the 2007 reporting period.

### **IX. Recording the Service Cost and Interest Cost of the 2007 Pension Expense**

(in millions)

Dr. Pension Expense	1,253
Cr. Projected Benefit Obligation (Service Cost)	1,253

### **X. Retirement Plan Obligation at December 31, 2007**

The amount of retirement plan obligation at end of the fiscal year totals to \$12,002 million. This is the amount of benefits the company estimates that it will pay to retirees in the future, based on service and interest costs, contributions, gains and losses, and other factors. Although this is the most comprehensive estimate created under the guidance of a professional actuary, different components of the total estimate are subject to change which could in turn either increase or decrease the total amount of pension obligation over time.

### **XI. Pension-Related Interest Cost for 2007**

The pension-related interest cost for the year is reported as \$656 million on the financial statements. By dividing this number by the beginning balance of projected benefit obligation in 2007, it can be determined that settlement rate is equal to 5.6

percent (\$656/\$11,660). This rate does seem to be reasonable, especially when compared to the rates of other companies, such as General Motors at 6.4 percent.

## **XII. Benefits Paid**

In 2007, benefits paid from the plan totaled to be \$481 million. This amount was paid from the plan assets of the company, not through the company's cash. The amount of benefits paid decreases the retirement plan obligation and decreases the total amount of plan assets. The journal entry to record the payment of benefits to employees is as follows:

Dr. Retirement Plan Obligation	481
Cr. Plan Assets	481

## **XIII. Consider Johnson & Johnson' Retirement Plan Assets**

### **i. Value at December 31, 2007**

The value of retirement plan assets at the end of the 2007 reporting period is \$10,469 million. This is the total balance in the company's plan assets that will be paid in benefits over time to retired employees.

### **ii. Expected Return vs. Actual Return in 2006 and 2007.**

In 2006, the expected return on plan assets was \$701 million, while the actual return was \$966 million. In 2007, the expected rate of return was \$809 million, while the actual return received was \$743 million. Although these differences may seem significant, they are immaterial when compared to the total amount of pension expenses and the company's earnings and total expenses. The actual return is the better reflection of the company's pension expense because it is the real amount received by the company, however, the company should try to underestimate the

expected return on plan assets when possible to ensure prudent and conservative financial statements.

**iii. Contributions**

In 2007, Johnson & Johnson contributed \$317 million to employee retirement plans, while the employees personally contributed \$62 million. In 2006, the company contributed \$259 million and employees contributed \$47 million, which is less than the previously stated 2007 contributions.

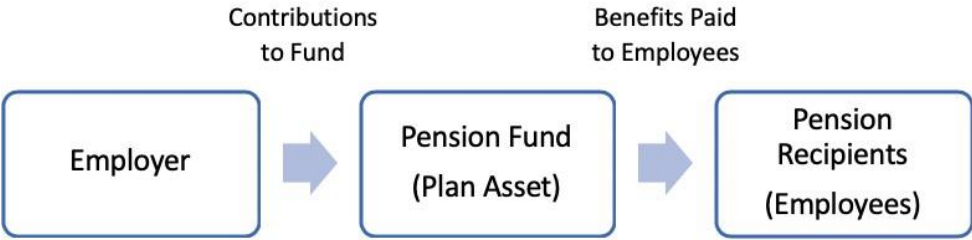
**iv. Types of Investments**

The retirement plan assets are debt and equity securities, as indicated in the notes to the financial statements.

**XIV. Level of Funding**

The retirement plan is underfunded at the end of both years. This creates a pension liability, which is recorded on the Balance Sheet in the non-current liability section.

**Appendix - Pension Plan Funding Flowchart**



**Case 11: The Balance Sheet Model of Financial Reporting**

**April 28<sup>th</sup>, 2019**

## **Executive Summary**

This case focused on a report produced by Dr. Ilia Dichev and the Center for Excellence in Accounting and Security Analysis (CEASA) at the Columbia School of Business. The purpose of this paper was to explore the two prominent approaches to financial reporting, the balance sheet method and the income statement method. Although both approaches are similar in nature, there are clear benefits and drawbacks to each, which are described in detail within Dr. Dichev's paper. Additionally, the author introduces a new approach to financial reporting which would allow for the distinction between different sources of revenue, which inevitably strays away from the bottom net income line.

This article opened my eyes to the complexity behind the conceptual framework and the various standards set and published by the Financial Accounting Standards Board (FASB). Each of these concepts seem so simple and straightforward when we learn them in class, but this article taught me that there are years of research, opinions, and drafts that go into the creation and implementation of each standard and objective. Before reading this article, I did not understand that this was an ongoing process that will likely continue through my career in public accounting. Now that I understand the debate that is currently ensuing between the various opinions within the industry, I can watch the FASB make changes in real time that will directly affect my career and the entire accounting profession for years to come. Additionally, I will seek out opportunities to allow for my opinion on the matter to be heard, as many of the standard setting bodies hold rotations or temporary positions that would allow myself to have a hand in the important decisions that will be made. I hope that during my career I will see a



comprehensive change in the conceptual framework and all standards that will take into account the benefits and drawbacks of each method and will allow for a unified set of guidance for all public companies, both here and abroad, to follow.

### **I. Summary of “On the Balance Sheet-Based Model of Financial Reporting”**

This paper, written in 2007 by members of the Center for Excellence in Accounting and Security Analysis, explores the two methods of financial reporting: the income statement approach and the balance sheet (fair value) approach. The author starts by covering the history of the two, explaining how both methods came to fruition and the major decision made in the 1970’s by the Financial Accounting Standards Board (FASB) to adopt the balance sheet approach as the basis for financial accounting for all companies in the United States. Since that time, the FASB has used this approach as the cornerstone for their standards and the conceptual framework, which are used to guide financial reporting today. The author also explains that the balance sheet method has been adopted by the International Accounting Standards Committee (IASC), which is the body that governs financial reporting in all countries outside of the United States. The two groups continue to work to bridge their standards to create one basis for accounting and financial reporting to be used by all countries, which would provide more consistent and comparable financial statements going forward.

The author then proceeds to discuss each approach in detail, listing the benefits and drawbacks of each. The balance sheet approach places emphasis on the valuation of assets and liabilities, with the view that the items on the balance sheet inevitably determine the amounts reported on the income statement and the overall earnings for the period. This view is favored by economists and, as stated above, is also used as the basis

for international reporting. However, the author notes that the balance sheet approach disagrees with the fundamental concept that most businesses base their operations on revenues and expenses, and assets are just “supplementary” and “temporary devices” that are subordinate and take a supporting role in the process of assigning revenues to expenses (Dichev 10). Additionally, it is common that managers focus on projecting revenues and related expenses for the period long before they begin to think about the assets needed for the predicted operations; very few businesses follow the balance sheet approach in their value creation process. On another note, investors focus on the income statement of a company’s reports when analyzing the financial statements, often noting the net income of a company rather than the assets or liabilities as reported on the balance sheet.

On the other hand, the income statement approach views revenues and expenses as the cornerstone of financial reporting, fundamentally because financial reporting is based on the matching of revenues to expenses. In essence, this approach holds the position that determining a company’s earnings is the goal of financial reporting, and mainly focuses on the firm’s operations and the value that arises from the business model. This approach is strongly supported investors, which the FASB notes as a primary user of financial statements, as they often use income statement numbers as the basis for their decisions. However, the FASB has chosen not to use this approach as the baseline for the conceptual framework and other standards due to the fact that the concept of matching revenues to expenses is “vague” (Dichev 6) and inevitably creates accruals and deferrals which are reported on the balance sheet but have significantly less economic substance compared to the other items reported, specifically assets and liabilities. In the Preliminary

Views document published and released by the FASB in 2006, it is noted that the importance of the income statement and earnings will deteriorate in the future, and therefore the balance sheet approach will continue to be the primary basis of financial reporting for all public companies.

The paper concludes with noting that while the practice currently uses a blend of both approaches, there is an effort being made to transition entirely to the balance sheet approach during the upcoming re-evaluation of the conceptual framework. However, the author argues strongly against this transition, and makes the argument for an alternative basis that should be used instead. In this new model of financial reporting, a clear distinction is made between a company's operating and financing operations. This would move away from the current practice, which often combines operating and investing activities under the operating section of financial statements. Additionally, the author argues that this new approach would deviate from the important "bottom-line" (Dichev 20) that is known as net income in an effort to differentiate between different sources of income, which would allow for investors and other users to create a more accurate prediction of future earnings.

## **II. Reflection**

As a student majoring in accounting, I never understood that multiple potential approaches existed and could be used to produce financial statements. We learned the conceptual framework and studied the multitude of standards that have been released by FASB over the past several years, and then used that information as the basis for our studies of the financial statements and proper accounting treatments thereafter. We never questioned or were taught to question the basis or foundation of the conceptual

framework and why the industry reports financial information in the method currently used and taught to accounting majors during their undergraduate studies. This paper changed the way I view the accounting industry and will continue to affect my career in the field for years to come.

One way in which I was challenged in my viewpoint of financial reporting after reading this article is that I always viewed assets, liabilities, revenues, and expenses as equally important. This is due to the fact that each number reported affects other financial statements, so in essence, all of the elements of the financial statements intertwined and interrelated. However, this article argues that one element of financial statements will naturally have importance over another, and different statements have more importance to different groups of people than others. The argument then becomes which approach should be used as the cornerstone of financial reporting. This was a debate that I had never considered before, due to my naïve viewpoint of the elements of the financial statements.

Secondly, I have always felt strongly about the convergence of the financial accounting standards released by both the FASB and the IASC. I hold the position that this is an imperative change that must be made, especially given the increased global presence that many companies have today. I believe that it would not only make financial reporting easier for these companies, but will also make financial statements more comparable, which is an enhancing quality of financial reporting and is crucial for users of financial statements. However, after reading this article, I understand that this solution is not as easy as I previously thought, as the IASC has already built many of their standards on the balance sheet approach, and the FASB here in the United States is continuing to re-

evaluate previous standards and make changes as needed. I believe that it would be best for the two groups to start from scratch and create a comprehensive set of standards for all companies to use. Ideally, this could be based on the alternative method introduced by the author at the end of the paper.

Finally, this paper led me to evaluate both approaches and consider which one I support as an accounting student and future professional. Although I find merit in the arguments presented for both sides, I do feel that it is important to remember why companies produce financial statements, which is primarily for the use of external parties like investors and financial analysts. These groups place a significant amount of importance on the notion of revenues, expenses, and earnings; therefore, financial statements should reflect that. Additionally, I feel that the income statement approach provides a better representation of the way the economy as a whole operates, by including cost-benefit evaluations and revenue-expense matching principles that managers and C-suite executives use on a daily basis when overseeing a company's operations.

### **III. Moving Forward**

After reading this article, I understand that the conceptual framework and other standards are not set in stone; they are evaluated on an ongoing basis and changes are made in response to the evolving economy and business world. Therefore, as a future professional in the accounting industry, it is likely that I will see many of these changes take place and feel the effects of the changes in my day-to-day work. However, after reading this article, I have developed a strong opinion on the debate between the two approaches and feel that there is a better way to develop the conceptual framework and related standards to create more comprehensive and useful financial statements. As a professional, I will have the

opportunity to voice my opinion within this debate, and possibly even pursue roles within various standard-setting bodies to actively affect the changes that are being made. This could be done through a rotation with FASB, the AICPA, or another group, which many public accounting firms offer and encourage. This is something that, after reading this article, I will likely pursue given my strong opinions on the debate between the supporters of the two approaches.

As someone that will be working with and certifying the accuracy of financial statements in my career, I will keep in mind that the financial statements are produced for the use of others, not for the use of the company. Therefore, when supporting and advocating for a certain financial reporting approach, like the one Dr. Dichev focused on at the end of the paper, I will remember that I should support a method that allows financial statements to be most understandable and comprehensive for the users, not one that I personally like better or feel would make my job easier.

On a larger scale, I feel as though this article has taught me that just because you may view something as permanent or set in stone does not mean that it actually is. Prior to reading this article and researching the debate between the two approaches, I viewed financial reporting as a process that was long-standing and permanent. This article proved that the foundation of accounting is one that is still evolving and changing today, with the help of many professionals and other members of the accounting and financial industry sharing their opinions on the best way to ensure comprehensive and accurate reports.

When I get settled into a long-term career at a public accounting firm, I will keep in mind that it is okay to question the way things are done and the methods a company uses, regardless of how long they have been in place. With technology changing and advancing

on a daily basis, we have all the resources at our fingertips to research and develop the best, most efficient way to solve a problem or complete a process like financial reporting.

## Works Cited

Dichev, Ilia D. *On the Balance Sheet-Based Model of Financial Reporting*. Center for Excellence in Accounting and Security Analysis, 2007, *On the Balance Sheet-Based Model of Financial Reporting*.



**Case 12: Performances and Earnings Measures Related to Google Inc.**

**May 2<sup>nd</sup>, 2019**

## **Executive Summary**

This case related to the valuation and reporting of earnings measures on the financial statements. This was done through a specific focus on Google, Inc., in which their recent financial statements were provided along with the stock market performance over a specified time period and as well as a press statement released by Google. This information allowed us to compare the amounts that were reported in the financial statements and the information provided in the press release with the performance of their stock after the information was released. This comparison allowed for an insight into how investors and other analysts viewed the information provided by Google, and how they reacted in the stock market. The non-GAAP performance measures reported by Google were also considered, and we evaluated the merit of reporting these figures within the financial statements and which factors are added or deducted from the GAAP figures to develop the non-GAAP measure.

The evaluation and research required for this case caused me to consider several controversial measures that are currently in contention among financial reporting bodies and publicly traded companies today. This debate centers around the reporting of non-GAAP financial measures, which are viewed differently among different professionals, as many accounting professionals disagree on their merit and whether or not they should be reported. With this being a currently ongoing debate, this case on Google's non-GAAP reporting measures allowed me to really consider the arguments on both sides and my stance on the issue in an objective manner. This is important both now as a student and in my future career as a professional because this is a current debate that will likely be ongoing for years to come. As someone who is now familiar with the situation, I feel

comfortable in my opinion and will strive to continue to stay updated in any changes that are made as a result of the discussion on non-GAAP financial measures.

**I. In the excerpts from press release titled “Google Announces Fourth Quarter and Fiscal Year 2013 Results”, the measures for GAAP and non-GAAP are different.**

**What explains this difference?**

The difference in the actual GAAP figure of \$2,886 million and the non-GAAP figure of \$3,568 million is the result of several different adjustments made by Google for various financial factors. In order to arrive at the non-GAAP results, Google added to net income reported under GAAP the following expenses or charges that were previously deducted: stock-based compensation expense, restructuring and related charges, and the net loss from discontinued operations. They also deducted from net income the income tax effects related to the stock-based compensation expense and the income tax effects related to the restructuring charges. I do agree with these adjustments made by Google; as long as they are still reporting the appropriate figures required by GAAP, they have the freedom to publish any additional figures they think investors or other analysts might be interested in. However, I do still believe that the measures excluded by Google in the non-GAAP calculation are important, and the company should be transparent in the manner in which they arrived at the non-GAAP income calculation.

**II. 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.**

Both the earnings performance and the stock price increased over the 2013 fiscal year.

**ii. Compare Google's 2013 stock price performance with the performance of the broader set of firms trading on the NASDAQ exchange.**

The stock price remained fairly consistent with the growth among other firms in the NASDAQ market, with the exception being in the fourth quarter when Google experienced significantly more growth than the market. During that time period, Google's cumulative stock return exceeded 60 percent, while the market only experienced 30 to 40 percent return rates.

**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"?**

The chart shows an increase in the price of the stock for the time period immediately following the date of the press release, so one could reasonably assume that the market was pleased with the content of the press release and Google's predicted future performance.

**III. 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?**

While Google reported earnings per share of \$12.01 (with the earnings figure

used being the non-GAAP calculation), the market analysts predicted earnings per share of \$12.20, which was well above what Google reported on the financial statements. However, the revenue reported was \$16.9 billion, which exceeded the revenue predicted by analysts of \$16.8 billion. Given the positive stock market reaction, the market was likely more focused on the high revenue than the earnings per share figure.

**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?**

The article mentions that investors could be pleased with Google's continual efforts to streamline its various operations, as well their plans to sell off an unprofitable operation related to the Motorola smartphones. Another factor that is promising for those interested in Google's operations is the 31 percent growth in advertisement clicks on the website, as well as the continued efforts by Google to make ads more conducive for smartphone users, especially those related to product listings.

On the other hand, investors seem to have hesitations toward the growing level of smartphone usage, which lowers the amount of desktop searches and inevitably hurts Google's business, with fewer companies willing to purchase ads on a desktop platform. This concern is related to the 11 percent decline from the prior fiscal year in the amount Google earned from advertisement clicks.

### **Works Cited**

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