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FINANCIAL ACCOUNTING TOPICS: CASES AND ANALYSIS

By

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

Oxford, Mississippi

2020

Approved by

Advisor: Dr. Victoria Dickinson

Reader: Dr. Mark Wilder

Table of Contents

Abstract…………………………………………………………………………………2

Case Study #1: Microsoft Power BI……………………………………………………3

Case Study #2: Rocky Mountain Chocolate Factory…………………………………….11

Case Study #3: Career Situations………………………………………………………...30

Case Study #4: Debt Securities Sales and Impairments…………………………………36

Case Study #5: City Case…………………………………………………………………...46

Case Study #6: WoldCom…………………………………………………………………..65

Case Study #7: Starbucks Corporation………………………………………………….75

Case Study #8: British Petroleum……………………………………………………….91

Case Study #9: Wendy's……………………………………………………………….102

Case Study #10: Johnson & Johnson…………………………………………………...113

Case Study #11: Columbia Business School…………………………………………...126

Case Study #12: Google……………………………………………………………...135

Abstract

This thesis consists of twelve individual case studies that analyze issues and topics related to the current financial accounting landscape. These cases take a practical and professional look at financial accounting the real current world, using technical understanding that has been gained throughout the coursework of the Bachelors of Accountancy major as well as professional skepticism and judgement to assess the situations. All of these cases were facilitated by the Patterson School of Accountancy over a year long period. These cases pertain to recent accounting changes such as pensions, the financial implications of recent scandals such as the BP oil spill, and recent evolutions in the climate of financial accounting such as advancements in technology due to data analytics tools. Research tools and data were partially provided in some cases whereas others required outside sources and research.

Case Study #1: Microsoft Power BI
Dr. Dickinson Accy 420

Will Boatright
September 5, 2018

Introduction

This purpose of this case study is to research a given data tool and to explain how it is useful for making business decisions as well as explain how the tool can make auditing and tax planning more efficient and effective. Microsoft Power BI is a user-friendly tool that takes data sets and pools them together to create visually pleasing reports and dashboards. Any business that uses data will benefit from Microsoft Power BI.

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

Power BI is a data analytics tool created by Microsoft that combines data sources to help create visually aesthetic dashboards and reports for users. The main objective of Power BI is to consolidate data from multiple places into one easily understandable platform. Power BI can take data from local files such as Excel, as well as external files such as Azure or Google Analytics, to create one singular visualization. This integration makes it possible for a company to see a full picture of their organization in one place opposed to sorting through each data set independently to find trends and information. If a member of the organization does not understand the data than they cannot give a valuable opinion. Visualizations are easily created and make reports understandable to the whole company. Power BI uses a cloud that can offer valuable decision-making information to an organization. This comprehensive data can be used to evaluable the possible effects of moving an office to another city or determining how different groups are responding to

your product offering. Computers are the only resource that needs to be in place to fully utilize this tool.

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

a. Auditing

1. A company might have all of their financial statement information on different platforms and software. Power BI allows the auditor to combine all of the information into one place and the auditor can create a client dashboard to keep track of it all. If the client uses audit log software for audit trails and another software to keep track of the general ledger, the auditor could immediately put this information onto that clients dashboard. This would be efficient because all parts of their audit trail and financial information could be consolidated into one place.

2. The auditor could create visualizations in Power BI to show financial statement data from previous years to date. This would allow the auditor to see any outliers in this years statements compared to past years. Outliers could then be examined and investigated further to ensure that they are correct. If a visualization shows that December revenue is three times higher than it has been in any of the past five years, this will stick out to the auditor. They can look further into their December revenue and make sure that the numbers are correct. This increases effectiveness by ensuring that client financial

statements are relatively consistent with the past and making it easier for the auditor to decide where likely errors are.

3. An auditor's findings can be challenged by their client or other members of their auditing firm. Microsoft Power BI allows the auditor to create a report of their results that is easy to understand. The dashboard also allows the auditor to keep all of their records in the same place as the report. This is effective because it easily communicates the results in one place. You can easily show the client proof of your results if they are challenged.

b. Tax Planning

1. Power BI Service makes tax planning easier. A tax planner who is deciding where to open an office can use the cloud to easily create a map that shows different tax rates for different states or countries. Power BI can integrate data into one set so that the tax planner can create a graph depicting corporate state tax on one axis and state income tax on the other. This would immediately show the planner which state has the lowest taxes overall.

2. Data modeling through Power BI can provide estimates about the future of the business. These estimates can be valuable for tax planning because they show what the company will look like financially. If a company has operations in a certain state with a progressive state corporate tax rate, forecasting can help determine the most probable tax rate that they will incur. This can also be used to help the company decide what to expense if they have the option. If they use data modeling through Power BI and realize that they will most likely barely be in a higher tax rate, they can decide to try to increase

expenses if possible. This is efficient because a company can easily forecast their taxes and are then able to plan in advance.

3. Power BI could be used to combine data sets that show how much Unemployment and Social Security taxes are going to be paid this year because these taxes are matched by the employer. A tax planner could use data to forecast how much the company will pay in salary the next year. Then it could combine that set with data that provides information on how much Social Security and Unemployment taxes are required for each level of salary. These data sets combined through Power BI would provide a forecast for future tax liability.

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

Microsoft Power BI is an easy purchase decision. It is considered one of the easiest analytics tools to use and requires no background in data analytics. Most computers already use Microsoft services, therefore implementation would be seamless. It is easy to look at because it is full of visualization. It has the ability to turn complicated spreadsheets into visually aesthetic and easily understandable reports. Power BI is easy to use, easy to look at, and most importantly, easy on the wallet. Power BI Desktop is free and allows all users to create reports and access their cloud of data, Power BI Service. Power BI Pro costs each user $9.99 per month and allows for dashboard sharing and collaboration. Microsoft offers a free trial as well so there is absolutely no monetary risk

associated. There is marginal to no training cost for Power BI. Anyone who can work excel and other Microsoft applications will have no problem with Power BI because it does the work for you. Even employees with no need for data modeling or advanced analytics can benefit from Power BI because they can turn their Excel report into a valuable visualization that their peers can easily understand.

Power BI will create cohesion within the organization because all reports and data can be shared company wide. Each member of the organization will be on the same page and analyzing the same visualizations. It will be easy for employees to access and understand other employees spreadsheets and data all in one place.

Staffing will not be effected by this purchase and nobody will need to be hired for technical support because of how easy it is to understand and apply to the business. It will impact future client engagements in a positive way through organizing documents and making analysis easier. The firm will be able to perform audit or tax with more precision and ease with this tool.

References

Davidiseminger. “Getting Started - Power BI.” Microsoft Docs, docs.microsoft.com/en-us/power-bi/guided-learning/gettingstarted?tutorial-step=1.

“Pricing for Power BI | Microsoft Power BI.” Power BI | Interactive Data Visualization BI Tools, powerbi.microsoft.com/en-us/pricing/.

The Honor Code:

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

Signed *Charles William Boatright*

Case Study #2: Rocky Mountain Chocolate Factory

Dr. Dickinson Accy 420

Will Boatright

September 12, 2018

Case Study # 2: Rocky Mountain Chocolate Factory

Dickinson Accountancy 420

Will Boatright

12-Sep-18

What I learned:

I learned how to enter dividends into retained earnings instead of using a dividends account. it.

I also learned how to use a few functions on Excel that make it a lot easier to use.

Excel is difficult but I the functions make accounting and record keeping easier than doing it on paper. Excel acts as an organizer and a calculator.

Part A

What accounts do you expect to see on the balance sheet? Which accounts constitute the majo assets? Which accounts constitute the major liabilities

Inventory, machinery, buildings, wages payable/expense, notes payable, sales revenue, selling expense. The major assets will be machinery and buildings.

Part B,C,D,F,G,I			

	beginning balance	purchase inventory	incur factory wages
cash & cash equivalents	1,253,947.00		
accounts receivable	4,229,733.00		
notes receivable, current	-		
inventories	4,064,611.00	7,500,000.00	6,000,000.00
deferred income taxes	369,197.00		
other	224,378.00		
net property and equipment	5,253,598.00		
notes receivable less current portion	124,452.00		
net goodwill	1,046,944.00		
net intangible assets	183,135.00		
other	91,057.00		
accounts payable	1,074,643.00	7,500,000.00	
accrued salaries and wages	423,789.00		6,000,000.00
other accrued expenses	531,941.00		
dividends payable	598,986.00		
deferred income	142,000.00		
deferred income taxes	827,700.00		
common stock	179,696.00		

additional paid in capital	7 ,311,280.00		
retained earnings	5 ,751,017.00		
sales	-		

franchise and royalty fees	-		
cost of sales	-		
franchise costs	-		
sales and marketing	-		
general and administrative	-		
retail operating	-		
depreciation & amortization	-		
interest income	-		
income tax expense	-		
Part E			
Accrued salaries and wages, depreciation and interest expense			

sell inventory for cash and on account	pay for inventory	collect receivables	incur SG&A	pay wages
17,000,000.00	(8,200,000.00)	4 ,100,000.00	(2,000,000.00)	(6,423,789.00)
5,000,000.00		(4,100,000.00)		
(14,000,000.00)				
	(8,200,000.00)			
				(6,423,789.00)
			3,300,000.00	
22,000,000.00				

14,000,000.00				
			1,505,431.00	
			2,044,569.00	
			1,750,000.00	

Rocky Mountain Chocolate Factory Inc.				
Ledger				
February 28, 2010				
receive franchise fee	purchase PPE	dividends declared and paid	other transactions	unadjusted trial balance
125,000.00	(498,832.00)	(2,403,458.00)	790,224.00	3,743,092.00
			(702,207.00)	4,427,526.00
			91,059.00	91,059.00
			(66,328.00)	3,498,283.00
			92,052.00	461,249.00
			(4,215.00)	220,163.00
	498,832.00		132,859.00	5,885,289.00
			139,198.00	263,650.00
			-	1,046,944.00
			(73,110.00)	110,025.00
			(3,007.00)	88,050.00
			503,189.00	877,832.00
			-	-

			(2,885,413.00)	946,528.00
		3,709.00	(1.00)	602,694.00
125,000.00			(46,062.00)	220,938.00
			66,729.00	894,429.00
			1,112.00	180,808.00
			315,322.00	7,626,602.00
		(2,407,167.00)	-	3,343,850.00
			944,017.00	22 ,944,017.00

			5 ,492,531.00	5,492,531.00
			693,786.00	14 ,693,786.00
			1 ,499,477.00	1,499,477.00
			-	1,505,431.00
			(261,622.00)	1,782,947.00
			-	1,750,000.00
			-	-
			27,210.00	27,210.00
			2 ,090,468.00	2,090,468.00

adjust for inventory count	record depreciation	wage accrural	consultant report	pre closing trial balance	closing entries
				3,743,092.00	
				4,427,526.00	
				91,059.00	
(216,836.00)				3,281,447.00	
				461,249.00	
				220,163.00	
	(698,580.00)			5,186,709.00	
				263,650.00	
				1,046,944.00	
				110,025.00	
				88,050.00	
				877,832.00	
		646,156.00		646,156.00	
				946,528.00	
				602,694.00	
				220,938.00	

				894,429.00	
				180,808.00	
				7,626,602.00	
				3,343,850.00	3,580,077.00
				22,944,017.00	(22,944,017.00)

				5,492,531.00	(5,492,531.00)
216,836.00				14,910,622.00	(14,910,622.00)
				1,499,477.00	(1,499,477.00)
				1,505,431.00	(1,505,431.00)
		639,200.00		2,422,147.00	(2,422,147.00)
		6,956.00		1,756,956.00	(1,756,956.00)
	698,580.00			698,580.00	(698,580.00)
				27,210.00	(27,210.00)
				2,090,468.00	(2,090,468.00)

post closing balance
3 ,743,092.00
4 ,427,526.00
91,059.00
3 ,281,447.00
461,249.00
220,163.00
5 ,186,709.00
263,650.00
1 ,046,944.00
110,025.00
88,050.00
877,832.00
646,156.00
946,528.00
602,694.00
220,938.00
894,429.00
180,808.00
7 ,626,602.00
6 ,923,927.00
-

-
-
-
-
-
-
-
-
-

Part H				Rocky Mountain Chocolate Factory Inc.		
				Income Statement		
				Year ending February 28, 2010		
Revenues:						
Sales	22,944,017.00					
franchise and royalty fees	5,492,531.00					
total revenues:		28,436,548.00				
Expenses:						
cost of sales	14,910,622.00					
franchise costs	1,499,477.00					
sales and marketing	1,505,431.00					
general and administrative	2,422,147.00					
retail operating	1,756,956.00					
depreciation and amortization	698,580.00					
total expenses:		22,793,213.00				
Income from operations:		5,643,335.00				
Other income:						

interest income		27,210.00				
Income before taxes:		5,670,545.00				
Income tax expense:		(2,090,468.00)				

Net Income:		3,580,077.00				
EPS:		0.60				

Part J					
Assets:			Liabilities:		
Current Assets:			Current Liabilities:		
cash and cash equivalents	3743092		accounts payable	877832	
accounts receivable	4427526		accrued salaries and wages	646156	
notes receivable, current	91059		other accrued expenses	946528	
inventories	3281447		dividends payable	602694	
deferred income taxes	461249		deferred income	220938	
other	220163		Total Current Liabilities:		3294148
Total Current Assets:		12224536	Total Deferred Income Tax:		894429
Total Net Property and Equipment:		5186709	Total Liabilities:		4188577
Other Assets:					
notes receivable less current portion	263650				
net goodwill	1046944				
net intangibles	110025				
Other	88050				
Total Other Assets:		1508669			
Total Assets		18919914			

Rocky Mountain Chocolate Factory Inc.	
Balance Sheet	

28-Feb-10	
Equity:	
common stock	180808
additional paid in capital	7626602
retained earnings	6923927
Total Equity:	14731337

Part K				
1.operating				
2.operating				
3.operating				
4.operating				
5.operating				
6.operating				
7.operating				

8.operating				
9.investing				
10.financing				

The Honor Code:

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Signed *Charles William Boatright*

Case Study #3: Career Situations
Dr. Dickinson Accy 420

Will Boatright
September 17, 2018

Introduction

The purpose of this case study is to analyze and debate our individual opinions regarding a few situations that apply to accounting majors at The University of Mississippi. The first two situations are a few students discussing whether or not to go to law school and whether accounting is the best major for students interested in going into investment banking or consulting. The third situation is a student considering whether or not to transfer their job offer. All of these situations apply to most accounting majors at The University of Mississippi and are important to discuss.

1. The first student says that he wants to go to law school and then go into the field of tax law. He supports this by saying that they make a lot of money. He also mentions that he wants to complete an accounting internship before law school. The second student refutes his idea of interning in a field that he does not want to enter.

I sympathize with the first student who wants to go to law school. It was easy for me to sympathize with him because the thoughts he presented have been on my mind for the past few years as well. I sympathize with him for wanting to complete an accounting internship. An internship is still a good idea for a student wanting to go to law school because it gives them one last chance to make sure that law school is what they want to

do. It also gives them valuable work experience at a major company. The internship is still applicable because many facets of the tax law field and the tax accounting field intersect. Law school makes an accounting major more valuable because accounting is the skeleton of business and law is the skeleton of society. It is very valuable to have a background in both. Law school is also valuable because it can open the door into high paying and sought after specializations such as tax law and even get a J.D. / Masters in Tax. However, these pros must be weighed against the cons. A masters in tax is much cheaper and takes less time to complete opposed to law school. This allows a student to spend precious years climbing the corporate ladder while the other is in law school. First year salaries for employees with a law degree at accounting firms is higher, but this eventually evens out so compensation should not weigh the students decision too heavily. The student needs to follow their heart and their gut to decide on whether or not to go to law school. If the student is genuinely interested in the American legal system, they should go to law school. However, the student should intern regardless of their decision because that is valuable work experience and will help the student make the right decision for their future.

2. The first student is not interested in accounting. They are going through the program because it is a strong major at The University of Mississippi and hope to go into other fields of business such as investment banking or consulting. The other student believes that if the student does not want to do accounting they should switch their major to finance.

Accounting is the best path at The University of Mississippi to go into other types of business such as investment banking or consulting. As mentioned previously, accounting is the skeleton of business and financial proficiency depends on understanding the balance sheet and income statement. Accounting harps on these fundamentals and forces students to understand the financial statements. This applies to any university and especially to The University of Mississippi. Our accounting program is rigorous and well respected, therefore a student graduating from the program has proven their work ethic as well as their understanding of financial statements and concepts. The accounting degree makes it more difficult to get your foot in the door for positions such as investment banking, but those jobs are incredibly demanding and time consuming. Therefore, a student who wants to go to into that field should prove themselves and their financial desire by double majoring in both accounting and finance. It is not easy to do but neither is investment banking. The other route is to major in accounting, get a CPA certification and transition into a different financial role. Early success at a major accounting firm along with a CPA proves an individual's work ethic and financial competence. Students with a finance desire should stick with accounting and either double major in finance to prove themselves to financial companies or prove themselves with a CPA and work experience at a demanding accounting firm.

3. <u>The student emailed Dr. Dickinson about wanting to go back to the Dallas office after interning in Washington D.C. at a Big Four firm. The student is from Dallas and says that he wants to go back home regardless of if the same firm will let him switch his offer. Should the student try to transfer their offer?</u>

The student should try their best to stay at the D.C office for at least two to three years. The student needs to give the new city some more time because moving to a new place is difficult and can take time to pan out. The student also needs to give it a few years to give back the firm's investment on them. The firms put a lot of work and effort into recruiting and the student would ruin their relationship with the office if they left. There are certain urgent situations that require a student to request an offer transfer, but they should stay for a few years under normal circumstances. The last reason that a student should give D.C. a few years is because initial job offers are very competitive and spaces are limited. It will be easier for the student to spend a few years in D.C. and request a transfer to the Dallas office. The student should work at the D.C. office in the meantime if he is able to transfer his offer to help pay their investment on him and to leave a positive impression on the D.C. office.

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Signed *Charles William Boatright*

Case Study #4: Debt Securities Sales and Impairments

Dr. Dickinson Accy 420

Will Boatright

October 2, 2018

Introduction

The purpose of this case is to discern the purpose and applicability of debt security impairment. In particular, this case shows a potential grey area in accounting for impairment of these types of securities because it is dependent on intent and ability to hold them. There are two tests that need to be run to determine impairment on these securities. First, the bank needs to decide if the decrease in value is due to credit loss. If not, it must be from interest rate fluctuations. The case states that there are no credit issues so we must decide if the bank has the ability and intent to hold the securities until they can recover. If so, the securities are not impaired. _Ability can be difficult to determine; however, the intent of the bank is even more difficult to determine. This issue is particularly important for bank regulators because the treatment of impairment has large implications on the bank's capital ratios. This is important because if a bank does not meet their capital ratios they will fail and shut down. This case is important because of how subjective "intent and ability" is, especially when bank failure looms. The difference between a succeeding bank and a failing bank can be the difference in equity from impairment loss. Therefore, it is essential that banks operate honestly, auditors highly scrutinize banks intent and ability to hold securities and that regulators ensure that

banks impair when necessary in order to project accurate capital ratios because people keep their money in the bank's and could lose it all if the bank cannot keep their ratio's. This case taught me the importance and implications of fair value accounting. Until this point I saw the difference between the two to be marginal and little more than a difference in accounting opinions. This case shows that fair value accounting is important and can be the difference between a well-capitalized bank and a bank shutting down.

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

Five of the seven securities have a lower fair value than amortized cost and are impaired in 20x2 because Generic bank has the intent and ability to sell the securities before they recover. According to Deloitte's IAS Plus, "In assessing whether subsequent sales of impaired debt securities are consistent with an entity's "lack of intent to sell" assertion as of the balance sheet date, an entity should determine when it decided to sell the impaired debt security," (IAS Plus 3). It can be determined that in 20x2 Generic Bank had already decided to sell the securities for a few reasons. First, they sold them early into 20x3 which shows that their decision was most likely made in 20x2. Furthermore, the passage mentions that the bank was concerned that selling the securities in 20x2 would impact assertions that it has the intent and ability to hold them. This shows that they have decided to sell the securities in 20x2 and simply deferred the sale until the next period to avoid impairment loss. Lastly, the bank has other means to raise capital. This proves that

they had the intent to sell because they did not have to but rather chose to sell them. Generic Bank could raise capital in other forms and choose to hold onto the securities until they recover. Therefore, they had an impairment loss in 20x2. It is clear that they had the intent and ability to sell the securities by year end and chose to defer the sale. Five of the seven securities sold were in a loss position in 20x2 and should have been impaired down to their fair value.

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

There is no impairment on the other securities with a loss. There is no evidence in the case that shows the bank's intent to sell the securities. It can be assumed that they do not have liquidity needs other than other than the bonuses freed up by the previous seven securities. Deloitte Dart states that, "If the intent to sell does not exist, the entity must next determine whether it is more likely than not that it will be required to sell the impaired debt security before recovery of its amortized cost basis. In making this determination, the entity should consider (1) the factors that might require the entity to sell the security (e.g., working capital requirements or regulatory obligations)," (Background 4). The case mentions that the bank is well capitalized and therefore has no need to sell the securities before they recover for regulatory obligations. Furthermore, the case states that "the bank claims that they have the intent and ability to hold these

securities until they mature or the unrealized losses recover. This in conjunction with their capitalization shows that they have no apparent need or desire to sell the securities and are therefore not impaired.

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

The answer changes for both roles. An auditor must scrutinize the banks decision and look at objective measures and data that proves intent and ability further than the claims of the bank. The auditor should look at the bank's history. If the bank typically sells their securities before maturity than the auditor should consider impairing them because the banks history would prove intent to sell. According to The Journal of Accountancy, the auditor should consider impairing if the following factors exist: "Fair value is significantly below cost. The decline in fair value has existed for an exerted period of time. The financial condition of the issuer has deteriorated." (New Guidance 5). Heather Herring should determine if the fair value is significantly below cost. This can be subjective and in order to impair the fair value should be very well below cost. Heather should look at the history of each security and determine how long the fair value has been below cost. If the fair value has been below cost for years than she should consider impairing those securities. The bank regulator should apply even more scrutiny when deciding if the securities should be impaired. Banks must maintain a roughly 10% capital ratio to survive. If the securities are impaired, the bank's capital ratio is reduced and the

bank can fail. Furthermore, the case states that a large portion of the banks investments are commercial real estate securities which are more volatile than other types of securities. Mondaq's website mentions that, "Dodd Frank imposed special higher capital requirements on loans categorized as "high volatility commercial real estate" ("HVCRE") loans," (Dodd Frank 6). Therefore, the bank regulator should take extra precaution on deciding if the real estate loans are impaired because they are more volatile and could push the bank underneath the heightened commercial real estate capital ratio limits. It is essential for consumer safety that the regulator applies strict scrutiny when determining the impairment of securities.

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

The securities that are at a loss position would still be impaired despite the overall securities sold having a net gain position. According to Deloitte DART, "Under ASC 320, a debt security is considered impaired if its fair value is less than its amortized cost basis," (Background 6). This shows that each security is impaired based on its own fair value opposed to the entire portfolio. The securities with a loss are written down to their fair value and upon the sale each are taken off the books at their gain or loss on the sale regardless of their impaired status. This gain or loss on sale is reported directly to net income in the period under other gains and losses. The statement from Deloitte provides a clear answer to the second question as well. A security has to have a fair value below its

amortized cost to be considered for impairment. Therefore, there is no impairment loss on any of the securities if they are all in an unrealized gain position.

5. Now assume that Generic Bank is adequately capitalized rather than well capitalized. And the bank desires to sell securities to improve capital ratios and to fulfill other borrowing obligations as they come due. Securities may not represent the only asset available to Generic Bank to sell, but access to other forms of borrowing to meet liquidity needs has become more limited. Assume that Generic Bank does sell the aforementioned securities shortly after year end in early 20x3. Does Generic Bank have an impairment loss on securities other than the seven securities sold?

The other securities with a loss are impaired. The answer comes from the definition of an impaired debt security previously mentioned above. Deloitte states that, "If the intent to sell does not exist, the entity must next determine whether it is more likely than not that it will be required to sell the impaired debt security before recovery of its amortized cost basis. In making this determination, the entity should consider (1) the factors that might require the entity to sell the security (e.g., working capital requirements or regulatory obligations)," (Background 7). The intent to sell the other securities cannot be determined because the bank has other assets that they could sell. However, they are still impaired because of the factors that could require them to sell the security. They have a capitalization regulatory issue. They also need to pay off obligations as they become due. Therefore, at any point in the year the bank might need to sell certain securities. Their ability to hold the securities has been compromised and the securities in a loss position

need to be impaired. Their intent is possibly still to hold the securities but they might not have the ability to hold. This meets the requirements to impair the securities. The bank regulator and auditor have a duty to make sure that these are impaired because the bank is closer to being shut down than it was when it was well capitalized. The bank might need to shut down if the impaired securities damage the capital ratios enough.

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The Honor Code:

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

Signed *Charles William Boatright*

Case Study #5: City Case
Dr. Dickinson Accy 420

Will Boatright
November 7, 2018

Introduction

The purpose of this case is to analyze key factors for determining a city to intern and subsequently work in. The questions range from monetary issues such as taxes to social issues such as local organizations to take part in. Many questions require research as well as in depth analysis of issues previously unthought-of. The questions and research related to the questions provide clear answers about pertinent questions concerning selecting the right city to intern in. My top city is Washington DC and my second city is New York, NY. I am not particularly knowledgeable about either so this case provides a lot of research necessary for making this decision. The issues in this case are very important to consider and have given me a better perspective on the cities that I am choosing between as well as an understanding of the logistics of living in each city. Taxes, laundry, grocery stores, transportation costs and accessibility are all issues that I have previously not considered or researched. However, these are important to consider and the results that I found on these topics affected my decision process while deciding between the two cities.

1. What is the population?

Washington DC: The population of Washington DC is 658,983. This makes Washington DC the 22nd largest city in The United States of America. However, the Greater Washington Metropolitan population is 6,097,684. This includes all suburban areas around the District in neighboring states such as Virginia and Maryland.

New York: New York has a population of 8.55 million, which makes it the most populated city in the United States of America. It has held this title since the very first US Census was conducted. Manhattan itself has a population of 1.63 million which contributes to the overall population of New York City.

2. Describe the climate and seasonal fluctuations.

Washington DC: The weather in Washington DC ranges from an average high temperature of 87 degrees in July to 42 degrees in January. They average 41 inches of rainfall, with the most precipitation coming in May, July and August. The climate is considered to be mixed humid. This climate applies to DC because they have over 20 inches of rainfall per year and temperatures drop below 45 degrees in the winter months. Overall, the weather and climate in Washington DC is very well representative of the national averages.

New York: Temperatures range from average highs of 88 degrees in August to 39 degrees in January. They have rainfall of at least 3.4 to 4.5 inches per month. The most amount of rain comes in the spring but there are no months of extreme or limited precipitation. During the winter months the low temperatures are below freezing, so the

precipitation turns into snow. New York is colder than the national average but is not as cold as many other cities in the state of New York.

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

Washington DC: Washington DC is located on the East coast of the United States of America between Maryland and Virginia. This means that DC is barely above sea level, averaging 100 meters above. There are two rivers that flow through the District: The Potomac and the Anacostia. The Potomac separates DC from Virginia and the Anacostia breaks off from the Potomac in northern Virginia and runs along the eastern side of DC. Washington is relatively flat with a few hills due to its proximity to the ocean. To the right is a topography map of DC. It shows the few hills as well as the rivers. The Potomac is on the left and the Anacostia is the river that breaks off to the right. Tributaries run through the city and surrounding suburbs as well. The Appalachian trail and many other hiking trails and parks are within a few hours of the city.

New York: New York City is relatively flat with a similar topography to Washington DC. The Atlantic Ocean is to the East, which flows into the New York Bay, located north of Staten Island. The Hudson River

flows on the West side of Manhattan and the Bronx. New York is right at sea level because of its proximity to the Atlantic Ocean. New York is home to Central Park, one of the most famous and largest parks in the world. With an area of over 800 acres, Central Park is a sigh of relief from the bustling city that surrounds it.

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

<u>Washington DC</u>: Washington DC has interesting tax rates because they are not a state. However, they have enacted state-like local taxes on income. They have an income tax rate of 4% up to 10,000, 6% from 10,000-40,000 and 7% from 40,000-60,000. The property tax is .85% of the value of the property. They have a sales tax of 5.75%. A single person making $50,000 would pay $8,195 in Federal and social security taxes as well as $2,900 in "state" taxes on their income using D.C.'s progressive income tax. I would not own property and would not pay this tax. Therefore, I would pay taxes of $11,095.

<u>New York</u>: New York has a local income tax in addition to state and federal income taxes. Their local tax rates range from 2.907% to 3.876%. A single person making $50,000 a year would pay $8,195 in federal income taxes, $2,361 in New York State taxes and $1,500 in local income taxes. In addition, their property taxes are .8% of the property value. This property tax is significantly less than most places in the country.

5. What transportation hubs are in the city?

Washington DC: Washington DC has many transportation hubs. Citizens and visitors have many options for navigating the city as well as traveling outside of the city. DC has a train station called Union Station that is located to the northeast of Capitol Hill. Amtrak offers trains that run along the East coast through the day and night. DC is also home to three airports: Reagan International, Washington Dulles International as well as Baltimore/Washington International Airport. Recently I had experience with a few of these transportation hubs. I flew into Reagan National Airport, and then took the Amtrak from Union Station to Baltimore/Washington International. Internally, the Washington Metro is a subway system that has six color coded lines. This system is one of the largest in America but is often considered easier to navigate than other major city systems according to locals that I spoke with. They also have a metro bus system that is not as heavily used but offers transportation to different parts of town.

New York: Most residents in New York City do not own a car. A local that I spoke with said that practically nobody drives their own car and that most people rely on the famous NYC subway system to commute. The subway cost a few dollars for a ticket but MetroCard's can be purchased for passengers who regularly use the subway system. New York is home to a world famous train station, Grand Central Station, as well as three major airports in the area: JFK International Airport, LaGuardia Airport and Newark Liberty International Airport. This makes traveling through the city and traveling to other cities very convenient.

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

Washington DC: The largest industries in Washington DC are federal government, education and tourism. This is due to DC being the nation's capital. In addition, there are countless universities such as American University, George Washington University and Georgetown to name a few. DC is full of museums, monuments and breathtaking historical landmarks that contribute to their tourism industry.

New York: New York is famous for their prevalence in the financial services industry. This is the largest industry in NYC, but there are many other large industries in the city that dwarf most other cities in America. These industries include: health care, professional services, retail trade, construction, information technology and leisure. In fact, 90% of the financial service related jobs in the state are located in New York City itself. Brian Roberson from KPMG noted that 52 of the Fortune 500 companies are New York City based. This shows that a lot of industries are well represented in NYC.

7. Describe the quality of the city's healthcare?

Washington DC: Health care in Washington DC is poor and a large concern. According to The Washington Post, "Less than 25 percent of Medicaid patients living east of the Anacostia River see a primary-care doctor in their Zip code. Despite efforts to expand services in Wards 7 and 8, many still call 911 emergency services for their basic health needs," (The Washington Post). This shows that DC has poor health care and needs to improve.

New York: New York City is home to 62 hospitals. This means that there is over 12 hospitals per borough on average. This amount of hospitals means that at any point a resident is not far from medical help. This also means that finding a qualified specialist for specific injuries and conditions is easier than any other city in America. The largest hospital in New York City is Mount Sinai Hospital next to Central Park with over 1,000 beds.

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

Washington DC: The most common type of crime is theft and the least common type of crime is murder. The crime rate has increased 1% this past year and the murder rate is up almost 50%. However, violent crime in total has gone down 7% this year. The neighborhoods to avoid are Washington Highlands, Columbia Heights, Brentwood, Ivy City and Historical Anacostia. DC is a large city that is considered to be dangerous in some places. It is important to know where you are in the city and where to avoid while traveling or living in the District.

New York: New York City has crimes of all types and there are very few areas of the city that are very safe. However, crimes are down in NYC this year. They are on track for less homicides than ever before and the crime rate is on track to be the lowest it has been in almost thirty years. The areas with the highest crime rates in NYC that are important to avoid are Downtown Brooklyn, Koreatown, various areas throughout Brooklyn and the

Bronx. While there are bad parts of NYC, there are no ultra-safe areas and it is important to know where you are at all times.

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

Washington DC: I expect to pay $1,500 in rent for the first few years. This would require me to split an apartment with a roommate if I want to live in a decent part of town. There is an apartment for rent north of DuPont Circle that is $1,500/month, 2 bedrooms,1 bath, the square footage is not listed but most comparable in this are around 500 square feet. I would need a roommate and it comes with two exterior parking spaces. There are no amenities but it comes with appliances.

New York: I would live in Manhattan and according to the people that I have talked to I expect to spend over $1,000 a month and have three or four roommates. Brian Roberson talked about the irrelevance of housing in NYC because of how busy people are. Between work and all the social events, the apartment is only used for sleeping and making a few meals. A three-bedroom apartment in Manhattan for four guests and one bath costs $3,500 a month. The square

footage is under 1,000 square feet. It comes with amenities such as heating, TV, Wi-Fi, a coffee maker and an elevator.

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

Washington DC: The typical mode of transportation according to the locals that I spoke with is the Metro subway system. Commute times vary, but assuming that I live at that apartment or in another reasonably close area, commute times are roughly fifteen to forty-five minutes. However, Metro has cons. One man that I talked to told me that it breaks down constantly which stops him from getting where he needs to be on time. He said that the issue is so bad that there is even a website sole dedicated to letting people know if Metro is down, https://ismetroonfire.com. If Metro is indeed "on fire", commute times could easily last over an hour.

New York: The typical mode of transportation in New York is the subway system as well as the world famous yellow taxi's. The base fare for a New York taxi is $2.50 and it cost an additional $.40 per fifth of a mile. I would either walk or take the cheap subway for transportation. Commute times are different, but according to people I have talked to, it will take 15-45 minutes to get to work in the mornings and afternoons. An older accounting student that I spoke with said that during his internship he walked to work and it took him roughly 15 minutes.

11. Where will you do your grocery shopping?

Washington DC: There are thousands of grocery stores in Washington DC. I would find one in my neighborhood or use an app to deliver food to my house such as Instacart. The issue with grocery stores is that I most likely would not have a car, so delivering them would be easier than attempting to transport the groceries from the store to my apartment.
New York: There are a lot of markets in NYC but a few locals have told me that it is much more convenient to order food or groceries to the apartment opposed to grocery shopping. I would have to budget for the amount of food services that are suggested to use.

12. How will you do your laundry?

Washington DC: The apartment that I found has a washing machine and a dryer in the unit so I would use those appliances. However, if the apartment that I find does not have its own washer and dryer I would find the closest laundromat or hand wash and dry my clothes. Neither of these options seem ideal so I will take the washing machine into consideration when selecting an apartment.
New York: Most places that I researched came with washing machines but if the unit that I lease does not have a washing machine I will either find a laundromat or hand wash my clothes in the sink. There are a lot of laundromats in major cities such as NYC, so if my unit does not have its own machine I would need to find a unit with a laundromat nearby.

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

Washington DC: I have a heart for veterans and respect them so much for serving our country so I would want to help them. In addition, DC is home to a lot of veterans as well as services and organizations that help them. To contribute, I would want to be active at Friendship Place, an organization that arranges housing for homeless veterans and offers food, job placement and medical services. I would also want to volunteer for Operation Renewed Hope Foundation, a group that helps veterans and gives counseling for PTSD and, if possible, help out at The Veterans Consortium, a group that offers free legal services to veterans.

New York: There are also a lot of veterans in New York City. I would try to find veteran organizations to be active in. I would try to get involved with the USO, the VA, or NY Serves, a nonprofit that organizes resources for veterans and their families.

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

Washington DC: I am a huge fan of sports and American History. Washington DC luckily has a lot of sports teams and historical museums. I would engage with The Redskins (NFL), The Wizards (NBA), The Capitals (NHL), The Nationals (MLB) as well as sightseeing. Growing up in Nashville I have not had the opportunity to attend any major sporting events besides football and hockey, so I would be ecstatic about the

opportunity to engage in baseball as well as basketball games. I would want to tour the White House and other governmental buildings such as the Capitol and the Supreme Court. I would want to spend a lot of my free time taking advantage of the free museums in DC as well.

New York: New York is the Mecca of sports and I would be ecstatic about all the opportunities to watch sporting events. I would also stay up to date with musicians in town and try to see as many good shows as possible. I have been a Giants fan for years because of Eli Manning, I would be excited to watch the Yankees play because of their importance to New York City and the sport of baseball as a whole. I want to see a live performance at the Madison Square Garden as well to take advantage of the famous musicians who come to play for the masses in New York City. Lastly, I would want to run at Central Park to get some fresh air and escape from the bustling city.

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

Washington DC: Transportation back to Nashville requires flying out of Reagan National Airport or Dulles International to Nashville International Airport. This costs roughly $400 round trip according to Kayak and is not a difficult flight to find. Some flights are direct but many make stops in Atlanta.

New York: Flights are relatively cheap and easy to find from New York to Nashville because so many people travel to New York and there are three airport options.

According to Kayak, a roundtrip flight costs roughly $400. There are a few direct flights, but most make one or two stops between destinations.

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

Washington DC: First, I owe roughly $12,000 in taxes which leaves $4,000/month. Rent cost $750, I'll allot $300 for groceries, $300 for other bills such as utilities and Wi-Fi and $650 for leisure and hobbies like sporting events and eating some of the delicious food DC has to offer. The Metro costs roughly $2-$6 per ride, so I will allot $100 of my budget for transportation. I will save $950 and use the last $950 on necessities that I run into and cannot avoid such as a trip back to Nashville or a Christmas presents for my family.

New York: Taxes in New York City are roughly $13,000 for someone who makes $60,000. This leaves me $3,917 per month. Rent costs $1,000, groceries will cost roughly$500, utilities and bills will cost approximately $300, the subway and taxi rides should be budgeted at $300 per month. These expenses leave $1,817. I will allot $300 to leisure activities like concerts and sporting events. The remaining money will be evenly split between savings and necessities that I do not anticipate such as gifts and other miscellaneous expenses.

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

I still want to live in both of these cities. This case has made me more excited about each of these cities and all that they can offer. While I do not look forward to possibly not having a laundry machine, I cannot wait to get to a big city. Washington DC is my preferred city because of the American History and political atmosphere. The history of America is fascinating and I could explore DC for years. In addition, I am interested in the public sector and governmental contracting. Washington DC is the ideal location for the advancement of my career and interests.

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The Honor Code:

“On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this case study.”

Signed *Charles William Boatright*

Case Study #6: WorldCom
Dr. Dickinson Accy 420

Will Boatright
November 16, 2018

Introduction

The purpose of this case is to look into the one of the largest accounting errors in the history of America. WorldCom was a very successful company, and a shining star of Mississippi. The errors that they made, however, caused not only their own downfall but affected thousands of investors. The issue in this case revolves around capitalization of assets opposed to expensing costs in the period. Assets and expenses are similar in some ways. They are both costs that a company incurs related to their operations that are essential for the creation of revenues. However, the major difference is that assets will create revenue in future periods whereas expenses are incurred to create revenue in the current period. Therefore, expenses are taken out in their entirety in the current period and assets are "capitalized" and expensed over the period that they create revenues. WorldCom had large expenses that they wanted to move off the income statement to provide more appealing financial statements to users. Therefore, they moved over three billion of their line cost items to asset accounts. This overstated their assets as well as their net income. It is important to understand this case and how important it is as an accountant to ensure that financial statements are presented correctly. Proper accounting would have damaged WorldCom and their stock value but in the long run would have saved their business, their executives lives as they knew them, and protected thousands of

investors. It is important to read this case and other information about this incident because it is easy to forget that criminals can wear suits, carry briefcases and drive sports cars too. This case shows the importance of proper accounting and the implications of accounting errors.

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

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

ii. In general, when should costs be expensed and when should they be capitalized as assets

i. Concept Statement 6 describes an asset as,"probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events," (FASB). Concept Statement 6 goes on to list the three characteristics of an asset as, "(a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred," (FASB). Assets are accounts that will provide future benefits to the organization in an effort for the company to make money. It is essential that the asset cannot be directed or used by other organizations. The expectation of an asset is that in future years it will provide benefits and the cost of

the asset will be depreciated to match those benefits(revenues). In contrast, an expense is defined by Concept Statement 6 as “Expenses are outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity’s ongoing major or central operations.” This shows that when future economic can no longer be derived it is an expense. An expense is the cost required to produce revenues. This includes cost of goods sold and other expenditures in the period that are required. Assets are depreciated as an expense in the period that they are estimated to create revenue. This is considered the matching principal.

ii. Costs should be capitalized whenever they will contribute to future earnings opposed to being a cost related to operations in the current period. Capitalization should only occur whenever the business has complete control and another company cannot have value in it. It should only be capitalized when control has passed to the company. Costs should ultimately be expensed or capitalized to reflect their impact on the creation of revenues. If an operational cost creates revenue in the period it should be expensed but if the cost creates revenues in future periods it should be capitalized and expensed in those future periods.

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

The cost results in a loss of cash and a debit to an asset account. This transaction does not affect the income statement at the time of capitalization. The balance sheet is barely effected if cash is paid because the loss in cash is offset by the addition of an asset at the same amount. The only change is an amount changing from a short term asset to a long term asset. If a loan or payable is used to purchase the asset, the balance sheet shows an increase in assets and liabilities at the time of purchase.

C. <u>Refer to WorldCom's statement of operations. What did the company report as line costs for the year ended December 31, 2001? Prepare the journal entry to record these transactions for the year. Explain in your own words, what these "line costs" are.</u>

In 2001, WorldCom reported line costs of 14,739,000,000. The journal entry to record these transactions for the year is:

XX/XX/2001	Line Costs Expense	14,739,000,000	
	Cash		14,739,000,000

These line costs are costs to make calls on their lines and to use the lines for certain purposes. These line costs should be expensed in the period because they only pertain to revenue in the period.

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

The costs that were improperly capitalized consisted of costs to complete phone calls. These costs were initially expenses in the period but were moved to be considered capital expenditures and capitalized. The transactions that give rise to these costs are when phone calls are completed and it costs WorldCom money for them to complete the phone call. This is directly a cost of their operations, as the operations of the business are to complete phone calls. These do not meet the definition of an asset because value will not be derived from this expenditure in future periods. The cost to complete a phone call only effect the period that the phone call was made.

E. <u>Prepare a single journal entry to record the improperly capitalized line costs of $3.055 billion for the year. Where did these costs appear on the balance sheet? Where on the statement of cash flows?</u>

The journal entry to record the line expenses are a capital expenditure would look like the following:

XX/XX/2001	Transmission Equipment	3,055,000,000	
	Cash		3,055,000,000

These costs appear on the balance sheet as an asset listed under transmission equipment. They showed up as a reduction to cash from investing activities as a capital expenditure. This is improper because the expenses were not a capital expenditure but rather an operating expense because of their lack of future implications on future earnings. These cash flows should be under the operating section opposed to the investing section.

F. In a sworn statement to the Securities and Exchange Commission, WorldCom revealed details of the improperly capitalized amounts (in millions) in 2001: $771 in the first quarter, $610 in the second quarter, $743 in the third quarter, and $931 in the fourth quarter. Assume that WorldCom planned to depreciate these capitalized costs over the midpoint of the range for transmission equipment as disclosed in note 1. Further assume that depreciation begins in the quarter that assets are acquired (or costs capitalized). Calculate the related depreciation expense for 2001. Prepare the journal entry to record this depreciation.

Transmission equipment is depreciated anywhere between four and forty years, therefore the midpoint of depreciation is 22 years. Depreciation for the first quarter capitalization totals 35 million (771/22). Depreciation for the assets added in the second quarter total 21 million ((610/22)*(3/4)). Assets capitalized in the third quarter total 17 million ((734/22)*(2/4)) of depreciation and the assets capitalized in the final quarter accumulate 11 million((931/22)*(1/4)). This leads WorldCom to a depreciation expense of 84 million in 2001. The journal entry to book this depreciation is the following:

12/31/2001	Depreciation Expense	84,000,000	
	Accumulated Depreciation		84,000,000

G. Use your answers to parts e and f above, to determine what WorldCom's net income would have been in 2001 had line-costs not been improperly capitalized. Use 35% as an approximation of WorldCom's 2001 marginal income tax rate, in your

calculations. State any other assumptions you make. Is the difference in net income material?

Net income for 2001 was 1,407,000,000. Since this number includes depreciation expense of 54,600,000 net of tax (84,000,000*35%), 54,600,000 must be added back to net income. In addition, the 3,055,000,000 in capital line costs must be taken out of net income because the should have been expensed this period on the income statement. This would decrease net income by 1,985,750,000 net of tax. In total, the correct net income can be found by the following calculation. 1,407,000,000+54,600,000-1,985,750,000. This makes WorldCom's net income (loss) for 2001 (524,150,000). This change takes WorldCom from a profit to a loss. Furthermore, it decreases their income by over a billion dollars. Therefore, this change is definitely material and would change the analysis of any user of their financial statements.

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Putra, Dharma. "Definition of Assets [FASB Concept Statement 6]." Accounting, Financial, Tax, 6 Aug. 2009, accounting-financial-tax.com/2009/08/definition-of-assets-fasb-concept-statement-6/.

The Honor Code:

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

Signed *Charles William Boatright*

Case Study #7: Starbucks Corporation
Dr. Dickinson Accy 420

Will Boatright
March 6, 2019

Introduction

The purpose of this case is to examine Starbucks' financial statements contained in their 10-K.. The balance sheet and income statement are common sized in order to understand the relative size of each item they reported and better understand how Starbucks is financed. The common sized financial statements are easier to understand, and they provide better analysis. In addition, this case provides insight to how Starbucks operates and the elections that they make regarding the estimates that they choose to report. Decisions and estimates must be made in the real reporting world and human discretion is a key factor. Estimates are most likely incorrect, but it is important to note that financial statements are never perfectly correct. It is not the company's duty to present perfect financial reports. Instead, their duty is to create materially correct reports that provide an accurate and genuine representation of the company's previous year or period. It is the auditor's responsibility to ensure that the company is reporting their financial records materially and correctly. In addition, it is also their responsibility to ensure that the company's internal controls work properly and opine on their results. In conclusion, this case shows that the results from financial statements are not black and white. They

contain estimates and special elections that can alter the numbers that are reported. It is important for auditors to ensure that these reports are materially correct and that the company and their internal controls operate correctly.

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

A coffee retailer's balance sheet should consist primarily of inventories, cash and property plant and equipment because their operations consist of constant cash sales of their inventory that they produce with machinery in store fronts. Therefore, Starbucks should have high amounts of these physical assets. Cash makes up 22% of their assets, inventory makes up 10% and property plant and equipment make up 28%. These assets are the three largest categories of assets which fits the bill for a retailer in the food and drink industry. Furthermore, retailer expenses should consist primarily of cost of goods sold because the are selling their tangible assets. This holds true because Starbucks cost of goods sold is 43% of their revenues. In conclusion, Starbucks is a retailer because their assets primarily consist of physical assets as well as their income statement having a large amount of cost of goods sold.

B. What financial statements are commonly prepared for external reporting purposes? What titles does Starbucks give these statements? What does "consolidated" mean?

The financial statements that public companies report are the balance sheet, income statement, statement of equity and the statement of cash flows. In addition, most companies report notes to supplement and explain relevant issues within the financial statements that could affect the decisions of an external user. Starbucks titles their income statement as a" Statements of Earnings", while the other financial statements are referred to in the fashion listed above. It is important to note that all their financial statements are considered "Consolidated" as well. This is an important distinction because it refers to the fact that Starbucks holds equity control in one or more organizations. In the case of a statutory consolidation, Starbucks and their subsidiary companies keep separate sets of books until their reporting date. On that date, the companies merge their books for reporting purposes to create their consolidated statements.

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

Public companies typically report four times a year. Three of these reports are quarterly reports that are referred to as a 10-Q. Companies also report financial statements at their year-end in a statement called a 10-K. The quarterly reports are not required to be audited and are intended to give users an update on the financial state of the business in quarterly increments. This statement is typically released within a month of the end of the quarter. The 10-K is prepared on an annual basis and must be audited. This report typically consists of the four major financial statements, notes and statements made from the

executive leadership of the organization pertaining to the state of the business. The primary objective of this report is providing an accurate and detailed overview of the business to potential investors and creditors. Both financial statement preparations are important, but the 10-K is the most important document that a company produces.

D. <u>Who is responsible for the financial statements? Discuss the potential users of the Starbucks financial statements and the type of information they are likely interested in.</u>

The company leadership as well as the auditors of the financial statements are responsible for their accuracy. Examples like WorldCom made the Sarbanes-Oxley Act essential. According to The CPA Journal, "The Sarbanes-Oxley Act of 2002, section 302, 'Corporate Responsibility for Financial Reports,' requires the CEO and CFO of publicly traded companies to certify the appropriateness of their financial statements and disclosures and to certify that they fairly present, in all material respects, the operations and financial condition of the company," (CPA Journal). This shows that the CEO and CFO are ultimately responsible for the information in the financial reports. The users of these reports are investors and creditors. The investors are highly interested in the dividend payout, earnings per share and other financial ratio analysis tools that can help them truly see the state of a business. The creditors are interested in the businesses balance sheet to determine their current financing. They look at debt ratios to make sure that the business is not over leveraged and will be able to pay off their current debts and potential future debts that they will lend.

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

Starbucks' external auditor is Deloitte. The opinion letters insist that the information in the report is the responsibility of Starbucks Corporation and that they believe that the numbers presented in the statements are materially correct. Furthermore, the opinions state that Starbucks' internal controls work correctly for the time being. It is important to note that Deloitte makes it clear that their controls could deteriorate, and Starbucks' could potentially be fraudulent. They do not promise the board of directors or external users that the statements are perfect, rather that they have completed a satisfactory report of the financial statements and the internal controls within the organization. The opinions are not released until the financial statements are released. For the 10-K report, the financial statements are released 90 days after the end of year to allow the audit team and the company to properly compile results that are materially correct.

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

filings. The company's Form 10-K can be found under annual filings and contains an Excel spreadsheet with financial statement data that may be helpful in creating the Common sized statements.)

Consolidated Balance Sheets (USD $)	Common-Size Balance Sheet 2013	Common-Size Balance Sheet 2012
In Millions, unless otherwise specified		
Current assets:		
Cash and cash equivalents	22%	14%
Short-term investments	6%	10%
Accounts receivable, net	5%	6%
Inventories	10%	15%
Prepaid expenses and other current assets	2%	2%
Deferred income taxes, net	2%	3%
Total current assets	48%	51%
Long-term investments	1%	1%
Equity and cost investments	4%	6%
Property, plant and equipment, net	28%	32%
Deferred income taxes, net	8%	1%
Other assets	2%	2%
Other intangible assets	2%	2%
Goodwill	7%	5%
TOTAL ASSETS	100%	100%
Current liabilities:		
Accounts payable	4%	5%
Accrued litigation charge	24%	0%
Accrued liabilities	11%	14%
Insurance reserves	2%	2%
Deferred revenue	6%	6%
Total current liabilities	47%	27%
Long-term debt	11%	7%
Other long-term liabilities	3%	4%
Total liabilities	61%	38%
Shareholders' equity:		
Common stock ($0.001 par value) - authorized, 1,200.0 shares; issued and outstanding, 753.2 and 749.3 shares (includes 3.4 common stock units), respectively	0%	0%
Additional paid-in capital	2%	0%

Retained earnings	36%	61%
Accumulated other comprehensive income	1%	0%
Total shareholders' equity	39%	62%
Noncontrolling interests	0%	0%
Total equity	39%	62%
TOTAL LIABILITIES AND EQUITY	100%	100%

Consolidated Statements Of Earnings (USD $)	Common Size Earnings Statement, 2013	Common-Sized Earnings Statement, 2012
In Millions, except Per Share data, unless otherwise specified		
Net revenues:		
Company-operated stores	79.19%	79.21%
Licensed stores	9.14%	9.10%
CPG, foodservice and other	11.67%	11.69%
Total net revenues	100.00%	100.00%
Cost of sales including occupancy costs	42.86%	43.71%
Store operating expenses	28.78%	29.46%
Other operating expenses	3.07%	3.23%
Depreciation and amortization expenses	4.17%	4.14%
General and administrative expenses	6.30%	6.02%
Litigation charge	18.70%	0.00%
Total operating expenses	103.87%	86.57%
Gain on sale of properties	0.00%	0.00%
Income from equity investees	1.69%	1.58%
Operating income	-2.19%	15.02%
Interest income and other, net	0.83%	0.71%
Interest expense	-0.19%	-0.25%
Earnings before income taxes	-1.54%	15.48%
Income taxes	-1.60%	5.07%
Net earnings including noncontrolling interests	0.06%	10.41%
Net earnings attributable to noncontrolling interest	0.003357%	0.00677%
Net earnings attributable to Starbucks	0.06%	10.40%
Earnings per share - basic	0.00007%	0.01376%
Earnings per share - diluted	0.00007%	0.01346%
Weighted average shares outstanding:		
Basic	5.03%	5.67%
Diluted	5.12%	5.81%
Cash dividends declared per share	0.01%	0.01%

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

i. Demonstrate that the accounting equation holds for Starbucks. Recall that the accounting equation is: Assets = Liabilities + Equity.

This is demonstrated through the formula: =B18-B37. B18 contains the total assets while B37 contains the total assets and liabilities. This formula equates to zero, so the assets equal the total liabilities and equity. The screenshot of the balance sheet reflects this formula in the top corner.

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

The major assets for Starbucks are property plant & equipment (28% of assets), inventories (10% of assets) and cash (22% of assets). Short term assets are 48% of total long-term assets. This is appropriate because they have a large amount of short-term liabilities to meet. In addition, their operations as a retailer requires that they have short term assets such as inventories and cash on hand.

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

Intangible assets are assets that cannot be physically held or moved. Goodwill is the asset that is created by acquiring another organization for a higher price than their net assets. It can not be allocated to a specific asset, so it is separated into its own classification. The intangible assets that might be on Starbucks' books include patents, trademarks, secret recipes for their coffee and other beverages.

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

Starbucks is financed through more equity than debt. Their equity totals to $4,482,300,000 while their debt financing only totals $1,299,400,000. This means that 22.47% of their financing comes from non-owners (4,482,300,000/5,781,700,000).

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

i. Review the revenue recognition policies of Starbucks discussed in Note 1 (Summary of Significant Accounting Policies). Does Starbucks record revenue when they receive cash from their customers (cash-basis accounting) or do they follow a different

rubric (for example, accrual accounting)? How does Starbucks record revenue on stored value cards (i.e., gift cards)? What challenges in measuring revenue do you observe? That is, are there any significant judgments management needs to make in recording sales revenues at Starbucks?

Starbucks records revenue at different points for different types of revenue. They record revenue when payment is tendered at the time of sale. This shows that Starbucks uses the cash basis for revenues in their stores. This is allowed because the product is always immediately exchanged for the money. They record revenue from gift cards when the card is redeemed in the store opposed to when the cash is exchanged for the card itself. Issues could be presented when initial non-refundable development fees are credited because they are recognized upon substantial performance of service. This measurement is subjective and requires management to make judgement.

ii. What are Starbucks' major expenses?

Starbucks' major expenses in 2013 include cost of goods sold, store operating expenses and litigation expenses.

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

Yes, the largest change to the cost structure is a 2.7 billion dollar expense for litigation.

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

According to Forbes, an arbitrator concluded that the coffee giant must pay $2.8 billion for prematurely terminating a deal with the Kraft Food Groups. It is considered an operating expense because it dealt entirely with operations. Starbucks failed to deliver on a contract where Kraft was responsible for proving coffee grounds that would go directly into operations. Therefore, the charge pertains to the operations of Starbucks and not the administration.

v. <u>Was the company profitable during 2013? During 2012? Explain your definition of "profitable."</u>

Starbucks was profitable in both 2012 and 2013. In 2013, Starbucks reported an operating loss of $325,400,000. However, their net earnings still totaled a positive $8,800,000. This means that the final income number that Starbucks and their subsidiaries collected was positive. Therefore, Starbucks was profitable in both 2012 and 2013.

I. <u>Refer to Starbucks' fiscal 2013 statement of cash flows.</u>

i. <u>Compare Starbucks' net earnings to net cash provided by operating activities and explain the difference.</u>

Net earnings were $8,800,000 while net cash provided by operating activities was $2,908,300,000. The difference largely comes from non-cash items on the income statement. The largest to note is a large chunk of the litigation expense. Most of this expense was not paid in cash during the year so it is added back to cash provided from operating activities.

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

According to their consolidated statement of cash flows, Starbucks used $610,400,000 for the acquisition of property, plant and equipment. The year before they only spent $129,100,000 on property plant and equipment.

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

Starbucks paid $628,900,000 in dividends during the fiscal year of 2013. However, they declared $1,631,800,000 in dividends according to their statement of equity. This number can be reconciled by a liability on their balance sheet for the difference. This is the amount that Starbucks has declared but they have not paid.

J. Several notes to the financial statements refer to the use of "estimates." Which accounts on Starbucks' balance sheet require estimates? List as many accounts as you can. Are any accounts estimate-free?

The accounts that require estimates are: goodwill, stock-based compensation, future asset retirement obligations, and inventory reserves; assumptions underlying self-insurance reserves and income from unredeemed stored value cards, property plant and equipment, patents, revenues, operating leases, foreign currency translations, deferred income taxes. All the accounts are either derived from an estimated total or they are recorded net of a number that requires an estimation. For example, a building is recorded at cost, but the number recorded on the balance sheet is an estimate because depreciation is not perfectly allocated.

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The Honor Code:

“On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this case study.”

Signed <u>*Charles William Boatright*</u>

Case Study #8: British Petroleum
Dr. Dickinson Accy 420

Will Boatright
April 3, 2019

Introduction

This case explores the financial effects of contingent liabilities. These liabilities can be produced by product warranties, potential litigation and other probable and estimable payments that will be made in the future. In particular, this case explores the British Petroleum oil spill in 2010. This case shows that there is a large difference between a product warranty and the contingent liability that is created by potential litigation expenses. While expenses for the total contingency are created in the year that it is established, product warranties can only amount to the cost of the product transferred while warranties for litigation can create an expense for much more than the cost of the defective asset itself. This case also shows that management and auditors must carefully assess contingent liabilities in order to report them correctly. Management must make assumptions regarding the probability that a liability will exist and then they must discern whether the amount of this liability can be estimated. It is important for the auditors to make clear and unbiased determinations regarding these two criterion. British Petroleum recorded a contingent liability of $20.00 billion on their books in response to their oil spill. These costs were recorded as a current expense to manufacturing expense. Therefore it is important for the auditor to correctly determine the value of the liability and corresponding expense because it can be the difference between a profit and a loss for the year. This case sheds light on the complexities of these liabilities. They are uncertain and must be estimated. The auditor should seek guidance from the business's attorneys to determine the probability that the company will legally be held liable for the

losses. Ultimately, the auditor is responsible for discerning the viability of the liability as well as the proper amount of the cost.

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

A contingent liability occurs when a company will likely have to make payments in the future. A contingent liability may also exist for current liabilities in which the amount is not certain. For accounting purposes, the liability is recorded if the amount is known and the probability of the liability is high. In other instances the company may disclose the liability in the notes of the 10-K or not disclose at all if the liability is not likely to occur in the future. It is important to note that if the liability may be estimated on the balance sheet if the general amount is reasonably certain. These liabilities occur from potential losses created from warranty expenses and lawsuits. Page twenty-five of BP's quarter three 10-Q states that they also have contingent liabilities created from an escrow account. A contingent asset may occur as well. According to IAS 37, a contingent asset occurs when, "a possible asset that arises from past events, and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity," (IAS Plus). This shows that the criterion for a contingent asset is similar to a contingent liability. Future events, or contingencies, must occur that are uncertain but likely to happen for a contingent asset to

be recorded. This treatment seems appropriate. If a company must report potential liabilities, it is fair for stakeholders to also view their potential assets.

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

British Petroleum has a two year product warranty for a product that they have purchased. This means that they will be reimbursed for the telescopic joints if the do not perform sufficiently at any time over the next two years. A warranty asset is most likely not placed on BP's balance sheet because their intention is to purchase working parts from a reputable manufacturer of telescopic joints. The warranty for GE Oil and Gas is a potential repayment for the price of the telescopic joint if it fails to work during the next two years. GE must calculate the estimated amount of warranties that will be used in the year and record that amount as a contingent liability on their balance sheet. This is necessary because GE manufactures a lot of these joints and it is fairly certain that at least one customer's joints will be defective at some point in the warranty period. However, the probability that BP's product will specifically not work is slim. These two situations

create a contingent liability on the GE books but do not record a corresponding asset on the books of British Petroleum because the probability of a defect for any of the joints is high for GE but low for BP's specifically.

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

Management must discern the probability of the product being defective during the warranty period as well as the cost of replacing or reimbursing the purchaser for the product. In the GE and BP example, GE must discern the probability of all of the telescopic joints that they sell becoming defective and assign a cost to the related warranty being fulfilled. According to Understand-Accounting.net, the seller must record the expected warranty expense and corresponding warranty liability at the time of sale as if the product will defect. The warranty claim will result in the seller paying the purchaser and taking the liability off the books. The expense was recorded at the time of the sale, so no further expense is necessary and the liability goes away. However, the damages claim is handled much differently. Management must discern if the claim is credible and then determine the cost associated with payment for damages. A contingent liability is added to their balance sheet if payment is probable. In addition, the warranty claim can only be made for the amount of the product while the new liability for the damages can be unlimited. In the BP example, GE is responsible for the warranty up to the amount that

the product was sold for. However, they may be liable and sued for much more if the oil spill is their fault. The costs of the lawsuits would not be a warranty expense, but rather a contingent liability for the amount of damages that they are being sued for. In essence, the warranty covers the cost of the product, and the lawsuit contingent liability covers the cost of damages that their product defect causes.

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

British Petroleum must estimate the cost of litigation and damage payments that are created from the oil spill. They must objectively decide if and which payments are likely and if they can make proper estimates for the cost. For example, they know that they will be sued and that they will have to hire a team of attorneys to represent them in court. While they are not positive how many hours will be billed or when litigation might occur, a litigation liability must be established because these future cost are probable and can be reasonably estimated. In contrast, the amount of restitution and damages that they will have to pay depends on the outcome of several lawsuits. For these expenses, BP must determine if they will reasonably win or lose these lawsuits. The cost of the lawsuits that they lose should then be estimated and recorded as a liability on their balance sheet. According the note two of the report, BP expensed the entire $20.00 billion of contingent liabilities resulting from the spill in the current period as manufacturing expenses. It is

important to note that they did not create a liability on the books for the expenditures that they consider, "not possible to estimate reliably either the amount or timing of such additional amounts," (note 2). This number is calculated as the present value of the future payments as well as the current ones. This treatment seems unfair because the expenses relate to cost that will be incurred in the future. However, these costs cannot be capitalized because they will serve no purpose in creating revenues in future periods.

D2. <u>If you were auditor for BP how would you draw a boundary around potential losses? Think of all people that could sue and is it reasonable for them to sue.</u>

The auditor should communicate with the attorneys for BP to sort through all of the current lawsuits as well as any laws that BP broke during the oil spill to determine who can sue them and who has legitimate claims. Therefore, the boundary should be drawn at the point where it is reasonable for a person or company to sue and the amount that their claim will be worth. Potential lawsuits could be filed from conservation agencies because there are laws that prohibit killing endangered species that were affected by the spill. According to the LA Times, "Three environmental advocacy groups sued <u>BP</u> on Wednesday, alleging the company's Gulf of Mexico oil spill harmed and killed both endangered and threatened species — one of hundreds of civil suits the oil giant will probably be fighting for years," (LA Times). It is reasonable for these agencies to sue because BP was negligent in their operations and it resulted in them breaking laws regarding the lives of certain species. Furthermore, fishermen in the area can reasonably

sue because the oil spill makes the water worthless for fishing until the oil is cleaned up. Their livelihood is affected by the negligence of BP and they will be held liable for the damages. Lastly, the local businesses surrounding the may sue BP for the losses that they incur directly from the oil spill. The first two examples should be accounted for by BP because the laws were clearly broken and they are completely liable for them. However, the local business lawsuits should not be accounted for as contingent liabilities for BP until further information and litigation occurs. For a local business to successfully collect from BP they must not only prove that their business was impaired after the incident but also that the spill was the direct cause of the loss of business. Many businesses suffer losses due to many reasons. It is inappropriate for the business to pin their losses on BP simply because they are a convenient scapegoat. Correlation does not always equal causation and it would be important for these local businesses to prove that BP directly caused their losses. In addition, agencies such as the EPA have large budgets to hire exceptional legal council to fight BP in court. In contrast, a local butcher shop who is affected by a slower economy in the town will not have the available funds to hire adequate council to fight a massive legal team from BP. These circumstances change if a large number of local businesses form a class action lawsuit and hire appropriate attorneys to fight BP. If a class action lawsuit is drawn up and payment seems likely, this falls into the boundary of potential losses.

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The Honor Code:

“On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this case study.”

Signed *Charles William Boatright*

Case Study #9: Wendy's
Dr. Dickinson Accy 420

Will Boatright
April 10, 2019

Introduction

This case examines the mechanics and implications of the equity method. Companies acquire others in order to gain access to supplies, enter new markets, and pool resources. When two companies form an alliance, it is typically considered a joint venture. The equity method of accounting for an investment is used if the parent company invests in twenty percent of the subsidiary or more. The purpose of the equity method is to consider the acquired firms income and losses as your own up the amount that you have ownership in that company. For example, if the parent owns thirty percent, then the parent records thirty percent of the subsidiaries reported income. This case shows that the investment account is the culmination of the purchase price and income, less amortization and dividends. The purchase price can be split into categories. The first is the book value of the acquired company's net assets. This is simply the net assets that are located on the acquired companies balance sheet at the time of the purchase. If the fair value of the net assets exceeds the book value, the assets must be written up to the fair value in the investment account. Any excess of the purchase price over the fair value is then attributable to goodwill. This means that if the acquiring company purchases the subsidiary for more than their market value, they have paid for extra intangible assets that they expect to create revenues in the future. Goodwill has been amortized in the past, however it may no longer be amortized in accordance with GAAP. The investment account will fluctuate throughout the years due to income, distributions and amortization. It is important to note that theoretically the investment account can have a negative balance. In general, the goal of the equity method of accounting is to report the

subsidiary's income, losses, and distributions as your own through an investment account that is an asset on the parent's books.

A. <u>In general, why do companies enter into joint-venture agreements?</u>

There are many reasons for a company to enter into a joint venture. The two companies can pool their resources and markets. It is often convenient for a business to enter into a joint venture with a foreign company. According to infoentreprenuers.org, "Joint ventures are especially popular with businesses in the transport and travel industries that operate in different countries," (Infoentrepreneur). This allows the company to enter the new foreign market without complete liability. In addition, the foreign company likely has knowledge to navigate the country's political and societal climate. Furthermore, the two companies can pool their resources together in an alliance to make investments that they could not make on their own.

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

The equity method is used when a company owns over twenty percent of another business. The essence of this method is that the acquiring company records the investment for the purchase price on the date of purchase. This investment account changes when the subsidiary records income or distributes a dividend. When the subsidiary records income, the parent records their ownership portion of the income and increases the investment account. When the subsidiary distributes a dividend, the parent receives cash but decreases the investment account. They decrease the investment account for dividends because they own twenty percent or more of the business. This means that they have influence over the subsidiary and are tied to their results. Therefore, when the subsidiary loses equity, the parent loses their asset in that equity. The income is listed as a separate line item for equity investment income. Therefore, the investment account consists of the purchase price, additions from subsidiary income and deductions from subsidiary dividends.

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

The difference between the purchase price and the book value of the net assets are allocated into two categories. Initially, the book values of the net assets are written up to their fair value on the date of acquisition. Therefore, the fair value of the company is recorded. The excess of the fair value over the book value is amortized over the life of the

individual assets and liabilities in a separate workbook. This workbook is presented only during financial reporting. If the two companies consolidate, this amortization is shown on the consolidated statements. If the consideration paid is still more than the fair values of the net assets, this means that the acquiring firm has acquired goodwill. This goodwill is held as a part of the investment account for the duration of the investment. The company reports a gain on a bargain purchase if the fair value of the net assets exceeds the purchase price. This gain is recognized on the income statement in the period of the purchase.

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

Wendy's includes two equity investments on their balance sheet. The two investments are with Tim Horton and a joint venture with an unnamed Japanese company. The total amounts within the investment accounts for 2011 and 2012 are $91.819 million and $87.620 million. This amount is recorded in an investment account on the balance sheet as a long-term asset called "investments". The total of this account is a culmination of the investment purchase and the subsidiaries income less dividends and amortization of the assets that have been marked up to their fair value on the date of the purchase.

E. Using information in Note 8, compare the amount recorded for Wendy's investment in TimWen at December 30, 2012 with Wendy's 50% share of TimWen's

equity at December 30, 2012. What accounts for the difference between these two amounts?

The investment account is recorded at $89.370 million. The equity in TimWen is recorded at $70.565 million. This difference is due to the difference between these two numbers is the excess of fair value over book value of net assets as well as goodwill. These items have been recorded in the investment account but are not on TimWen's equity section of the balance sheet. Rather, TimWen records their assets at their book value still, so half of their equity is lower than the investment account. The difference between these two numbers boils down to the excess of fair value, goodwill, and the amortization of the excess of the fair value.

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

i. How did Wendy's equity method investment in TimWen affect their earnings before taxes in 2012 and 2011? Where does this appear in Wendy's consolidated statements of operations?

The earnings are reported in the other revenues and expenses section of their balance sheet, particularly in other operating expenses, net, for 2012. When the TimWen records income, the journal entry produces a credit to an income account. This income from investments is then reported on the income statement. The net total is then recorded either

as another revenue/expense depending on the profit created by TimWen during the year as well as the amortization of TwimWen's assets to book value. In 2012, TimWen provided $13.680 million in earnings for Wendy's, but due to distributions and amortization, TimWen ultimately was responsible for a loss. This loss is buried in other operating expenses, net.

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

The entry would consist of the following:

12/31/2012	Equity Investment	13,680	
	Investment Income		13,680

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

The amount for amortization expense that stems from the excess of fair value over book value on the purchase date is $3,129. This amount is found on note 8 of the financial statements under "amortizations of purchase price adjustments". The entry would consist of the following:

12/31/2012	Amortization Expense	3,129	
	Equity Investment		3,129

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

Wendy's received $15,274 in dividends from TimWen in 2012. This amount can be found on note 8 and is listed as "distributions received". The entry would consist of the following:

12/31/2012	Cash	15,274	
	Equity Investment		15,274

G. Consider the information in the statement of cash flows.

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

Note 8 in the financial statements shows that TimWen reported income of $10,531. On the contrary, the Japanese subsidiary reported a loss of ($1,827). These totals together equal $8,724. This number is subtracted to find cash flows from operating activities. This treatment handles the income from the subsidiaries as a type of gain. Therefore, it needs to be subtracted to find the cash flows of the organization.

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

Note 8 shows that Wendy's received a $15, 274 dividend from TimWen during 2012. This amount is added on the statement of cash flows because the $15,274 adds to the supply of cash on hand. Therefore, the cash flows increase from the dividend despite the investment account decreasing.

References:

"Joint Ventures and Partnering." *Info*, www.infoentrepreneurs.org/en/guides/joint-ventures-and-partnering/.

The Honor Code:

“On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this case study.”

Signed *Charles William Boatright*

Case Study #10: Johnson & Johnson
Dr. Dickinson Accy 420

Will Boatright
April 19, 2019

Introduction

This case explores the mechanics of accounting for pension liabilities. It is important to note that the employer does not directly pay the employee upon retirement. Rather, they use investment firms to invest the money that they contribute. Furthermore, these invested assets are then used to pay the retirees. The employee and the employer contribute to a plan that is owned by an investment firm. This investment firm then invests the plan assets to create a return. Their goal is to create a return greater than the interest cost of holding the assets and to create gains large enough to pay the employee at their future salary levels. Upon retirement, the investment firm uses their capital from the plan assets to pay the former employees. This is important to note because the employee never exchanges cash with the employee for their pension plan. There are two types of pension plans. The first is a defined contribution plan where the employer does not guarantee the employee a set amount of retirement funds. Rather, the company promises to contribute a set amount of money into a fund that will be properly invested until the employee receives the benefits. In contrast, a defined benefit plan explicitly states the amount that the retiree will receive during their retirement. The employer must use actuaries to discern the correct amounts to anticipate paying. The largest difference between these two plans is that a defined benefit plan creates an obligation that the employer must pay. This, in turn, places a liability on their books. In contrast, the defined contribution plan does not guarantee a certain amount, so there is no liability on their books for the pension. This amount can significantly affect the balance sheet. Johnson & Johnson's balance sheet reports a $1.533 billion liability for their pension plan. This is a

liability that would not appear on the balance sheet if Johnson & Johnson strictly used defined contribution plans.

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

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

A defined benefit plan is a retirement plan in which the employer guarantees the employee a determined amount of cash, or benefits, upon their retirement. This number depends on the company, but they essentially pay the employer a percentage of their salary for the rest of their lives. This means that the employer is responsible for the set payment of the employee. On the contrary, a defined contribution plan means that the employer agrees to put a certain sum of money into an investment account for the employer to receive throughout their retirement. The employer is not responsible for a set payment to the employee upon retirement. According to note thirteen of the financial statements, Johnson & Johnson uses both defined benefit and defined contribution plans. The note also mentions that they offer healthcare benefits to retirees and their families.

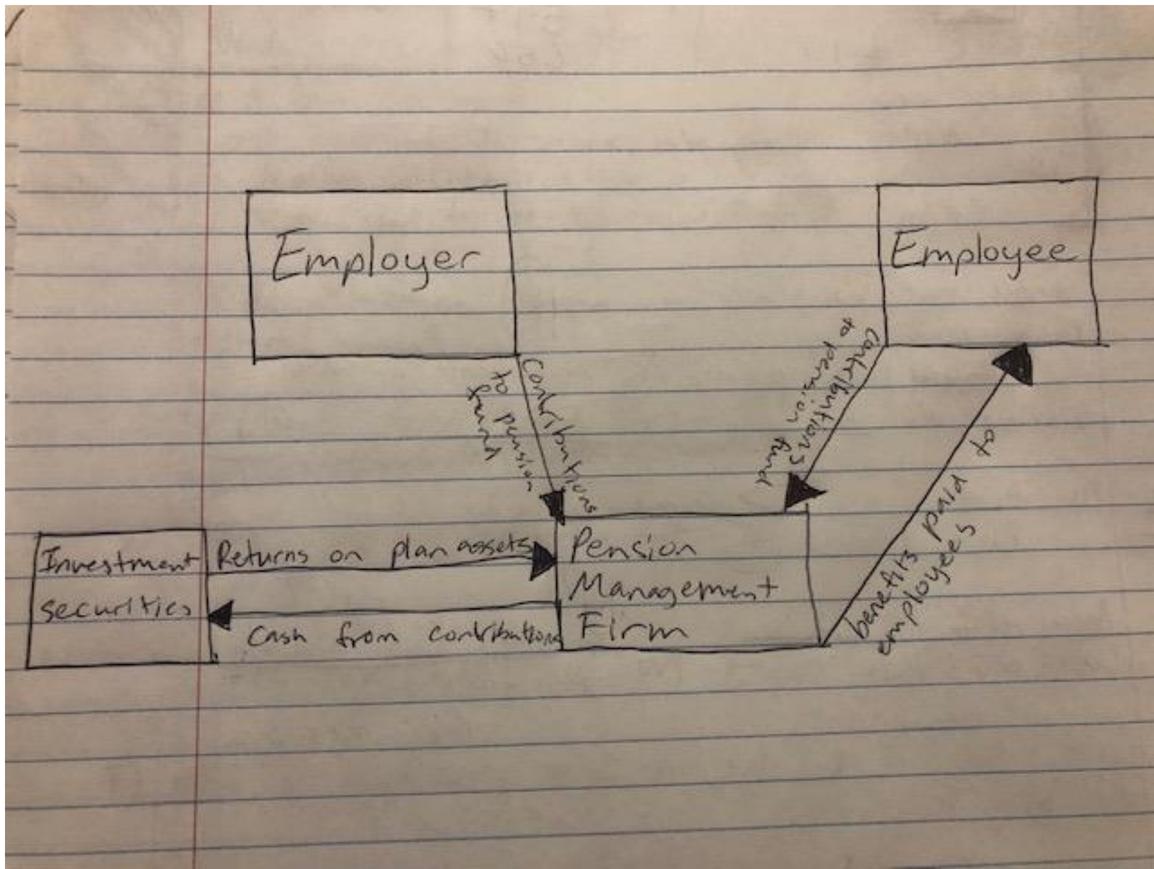
ii. Explain why retirement plan obligations are liabilities.

The only time that a liability is created from a pension plan is in the case of a defined benefit plan. This is because the company has promised the employer a sum of cash and they are obligated to pay the employer. Therefore, a liability is established for the amounts that the company owes the employee. However, there is no liability for a defined contribution plan. Rather, the company invests sums of money with no guarantee that the investment will provide a certain amount to the retiree. Therefore, there is no liability established when a defined contribution plan is used by an employer.

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

The actuaries must make assumptions regarding the amount of time that the retiree will live upon retirement. They also must make estimates about how long the employee will work for the company in addition to estimating how much the employee will make so that they can accurately estimate the projected benefit obligation to report. The current accounting standards require that the employer account for service costs based on expected future salary opposed to the current salaries. Therefore, the expected future salaries must be assumed.

A2. Diagram the cash flows between the parties involved in the defined benefit plan.



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

The plans service costs are the cost of the expected benefits to be paid to the employers in the future. This number is discounted to the present value and recorded as service cost. Interest costs are the cost associated with the unpaid projected benefit obligation. They are essentially the holding cost of the liability. Actuarial gains and losses are the difference between the projected benefit obligation from year to year. If the obligation is initially recorded too high, an actuarial gain will occur. On the contrary, if the projected

benefit obligation is initially too low, an actuarial loss will occur. Benefits paid to retirees is the actual amount that the retiree is paid. Under a defined benefit plan, this number is predetermined, and the employee receives the pension through their retirement.

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

The actual return on plant assets is the sum of gains generated from the investment by the employer. The employer gives the money to an investment firm who then invests the funds where appropriate. The actual return is the gains from the investment firms' investments with the assets. The company contributions to the plan is the amount that the employer funds the plan with. The plan assets will increase with contributions to the plan because the plan assets consist of the total contributions to the plan from the employer. The benefits paid to the retirees is the amount that the pension plan pays out to the employee throughout their retirement. The pension assets decrease whenever benefits are paid to the retiree.

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

The return on plan assets reported for the pension expense is the actual return. In turn, the return on pension plan assets is the expected return on the assets. The difference between these two numbers shows how the plan asset investment is performing against the expected performance of the assets. However, if the expected and actual return are different, this amount goes into other comprehensive income and effects the pension expense. The actual return is necessary for the pension expense because it is directly related to the actual expenses of the pension plan for the year.

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

There is an exact monetary value that can be placed on the defined benefits for the employee. Therefore, the amount is considered a liability because the amount will be paid in the future. However, healthcare benefits can not be estimated and are not a part of a defined benefit plan. These amounts cannot be reasonably estimated because the benefits are not defined. Therefore, these amounts are not reported on the balance sheet of the employer as a liability and do not increase the projected benefit obligation.

F. Consider Johnson & Johnson's pension expense detailed on page 61 of the company's annual report. Note that the company uses the term "net periodic benefit cost" to refer to pension expense.

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

The annual report never states the amount of pension expense explicitly. However, page 61 of the notes lists the totals for the components of the expense and then lists "net periodic benefit cost". This cost was $646 million in the year of 2007.

ii. Prepare the journal entry to record the service cost and interest cost portion of the 2007 pension expense.

The journal entry would appear as follows:

12/31/2007	Pension Expense	1,253,000,000	
	Pension Liability-Service Costs		597,000,000
	Pension Liability-Interest Costs		656,000,000

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

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

They reported a pension obligation of $12.002 billion at the end of 2007. This number represents the present value of the amount that Johnson & Johnson will pay to retirees through their defined benefit plan. The number is not entirely accurate because of a host

of actuarial assumptions that the number depends on. However, this is statistically the most accurate figure and is still relevant and important to know.

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

The interest cost for 2007 is $ 656 million. The average interest cost is 5.63%. This number is derived by dividing their interest cost by the beginning projected benefit obligation to get the average rate. This number is reasonable because page 61 of the report says that they used the market rate for “high quality, long-term fixed income instruments”. This is the appropriate market rate to use because it represents the rate of similar instruments with a similar maturity date.

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

The pension plan paid out $481 million in benefits to retirees in 2017. Johnson & Johnson did not pay cash for these benefits. They were paid out of the pension plan that they contributed to years ago. The only time their cash is affected is when they contribute to the plan. The amount of benefits paid reduces both the projected benefit obligation as well as the plan assets. The PBO decreases because the liability shrinks while the plan assets decrease because the assets leave the plan to be paid out to retirees.

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

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

The value of the assets is $10.469 billion at the end of 2007. This is the value of the contributions that Johnson & Johnson has made to the plan adjusted for dividends and gains from the investment of the plan assets and deducted for benefits paid out of the plan.

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

In 2006, the actual return was $966 million while the expected return was $701 million. In 2007, the actual return was $743 million, and the expected return was $809 million. These numbers are material and significant. The more accurate number is the actual return on the assets because the pension expense is calculated at the year end when the actual return is known. There is no need to include the estimated return on the income statement when the actual amount is known. This practice appears subjective and potentially inaccurate.

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

In 2007, Johnson & Johnson contributed $317 million while the employees contributed $62 million. These contributions are both larger than 2006 when Johnson & Johnson contributed $259 million while the employees contributed $47 million.

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

The majority of the American plan assets are invested in equity securities (79%). The rest of the plan assets are invested in debt securities (21%). Internationally, these percentages remain similar with the addition of real estate and other investments (1%).

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

The plan is underfunded at the end of both years. It is underfunded by $1.533 billion at the end of 2017 and $2.122 billion at the end of 2016. This amount is found on the balance sheet under accrued liabilities.

The Honor Code:

“On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this case study.”

Signed *Charles William Boatright*

Case Study #11: Columbia Business School
Dr. Dickinson Accy 420

Will Boatright
April 26, 2019

Introduction

This case analyses an article written by The Columbia Business School that discusses the differences and relevance of the balance sheet approach versus the income statement approach. The balance sheet approach is the method of accounting for value in which the firm's value is determined by the change in net assets over the period and altered by the amount of distributions. The income statement approach is the method that accounts for firm value by adding or subtracting the income or loss for the year. This article makes the argument that the balance sheet approach, which is supported by FASB, is not relevant and should be replaced by an alternate method. Their argument hinges on the fact that fair value assessments are volatile and potentially inaccurate. The article gives potential alternatives to the balance sheet method that involve separating operating and financing activities and erasing the notion of a singular "bottom line". The reason for this change stems from the large difference between assets that are used to create value from the operations of the business and those assets that are used for financing and creating value outside of operations. The assets that are used for financing should be measured at fair market value because they have external value and could be sold for more or less than their cost to the business. On the contrary, operating assets are used internally so their fair market value is irrelevant. These ideas would change the landscape of accountancy and the job of an auditor. It is important for the accounting community to have this discussion now because the world is becoming a smaller place. FASB and IASB are in a unique

place where they must come together and properly determine the correct accounting framework for the future.

A. Read and thoroughly summarize the attached article.

This article discusses the importance of certain financial statements. This article questions the importance and value of the balance sheet approach. The article begins by explaining the origin of the balance sheet accounting method. In the 1970's,

FASB determined that earnings can be deciphered by finding a firm's overall change in

value from one period to the next. Therefore, it is essential to understand value and

determine it in order to show a firm's change in value fairly against another firms. FASB

determined that the balance sheet method is a fair assessment of value and the change in value could be deducted from the change in the net assets that the company has a claim to. The article makes the argument that assets and liabilities are not important on their own. For example, a company owning a boat on its own is irrelevant. The value is derived from the company using that boat, or other asset, to create earnings efficiently. The same concept applies to liabilities. They are not important on their own, they are simply a vehicle for creating earnings in the period. The article goes on to point out that investors care about earnings more than balance sheet data. Investors are concerned with

the efficiency and profitability of the company's operations. These results will lead to

long term success. They look at projected revenues and cash flows first and foremost

while making decisions. The best place to find these figures is the income statement, not the balance sheet. They argue that the balance sheet is incapable of showing the value that is created by a firm. Further, the income statement method is the most accurate for property, plant and equipment because the income statement reports the internal depreciation of the assets. The article argues that fair market values of property, plant and equipment are irrelevant because the assets are predominantly used for internal value creation. The question is whether the asset has value outside of the firm. If it does not than it should be accounted for on a historical cost basis opposed to the fair market value. The article argues that fair value accounting is not reliable because the fair market values can change drastically overnight. The article points out that Enron's downfall stemmed from the liberties that they took with fair market and "mark to market" accounting. The article finally discusses potential alternatives to balance sheet accounting in the future. The first alternative is to separate operating from financing activities. This would require there to be multiple bottom lines and an increased number of financial statements. The most important aspect of financial statements should be their earnings. Therefore, the rules for determining the definition of revenue and expenses must be clear. There must be perfect cohesion between reporting revenues and matches the proper expenses. In conclusion, the balance sheet is currently over used as a determination of a business's value. The company's value is derived from the earnings that it can create in a period and the income statement method is the best portrayal of this.

B. How did reading this article change your current way of thinking?

This article changed my perceptions of earnings and the purpose of financial statements. The purpose of financial statements is to show the change in earnings over time. The balance sheet accomplishes this by listing out assets, liabilities and equity. Through this the company can discern the change in their net assets. It is defined that net assets are the value of the organization, so the change from year to year provides the change in value. However, the income statement approach views value as the earnings that a firm provides in a year through their operations. This article forced me to think about the purpose of financial statements, why we truly need them and if the current methods we use for them are correct. The first few years of taking accounting classes have shown me the correct way to account for transactions and report financials, but this article forced me to ask why we report finances the way that we do. This article changes the way that I view assets as well. Assets are simply the vehicle that companies use to derive value. It is irrelevant how many assets the company has if they cannot convert these into earnings. It also means that it is paramount to value property, plant and equipment assets at a historical cost because the earnings that they produce need to be matched with the cost of the asset which can be found from depreciating the asset at its historical cost. This article changed the way that I think about marketable securities in a similar way. The determining factor for fair market value versus historical cost should be whether the asset has the same value outside of the organization. For example, if a company owns a specialty machine that produces their products, the machine should be accounted for at historical cost because the value derived from the asset is internal. On the contrary, if the

asset is a marketable security than it belongs on your balance sheet at fair value because the asset could be sold immediately at a reasonable price. Therefore, the company has the fair value amount of assets. This article also changed how I feel about the importance of the income statement as it relates to earnings. Accountants are responsible for making sure that the financial statements are accurate so that investors can properly assess the organization. The article mentions that investors look at the income statement of a company to determine their value through earnings more than the balance sheet. Therefore, it is more important to ensure the earnings are properly reported. Income is properly reported when the revenues are correct, and the expenses are matched properly. This changed my way of thinking about earnings. Regardless of whether the balance sheet perspective or income statement perspective, FASB's objective should lie in making clear and appropriate decisions regarding the definition of revenues and expenses. These two definitions should be both equitable and inarguable. Two companies should display their earnings in a way that is consistent throughout. There are many alternative ways to make these decisions but the most important issue that FASB faces is determining the best way to create fairness throughout business.

C. How will you use this information in your future career?

This article has changed my way of thinking about the purpose of accounting and therefore the role of an accountant. As a future accountant, my main objective will be to ensure that earnings are properly recorded, but more importantly that the standard for reporting earnings is correct. The industry is moving further way from historical cost

methods and moving towards fair value assessments. While this article argues that historical cost is most important for internal purposes, I disagree. Fair values are volatile but so is economics. Interest rates are constantly changing as well as the landscape of businesses and industries. To ignore this because it is inconvenient and somewhat inconsistent for accountants is lazy and impractical. Value is derived from the earnings that an asset creates over the cost of the asset. If the asset itself appreciates in value, then it has created earnings that are equally as important as the earnings from operations that the asset creates. Likewise, if the asset depreciates in value, this directly decreases the value and earnings of the business equally as much as other costs reported on the income statement. However, I will still value the balance sheet in my career, and I understand the importance of the balance sheet. A company such as Uber proves the importance of the balance sheet for discerning the value of an organization and showing information that is valuable for investors that the income statement is not capable of. In 2016 and 2017 Uber showed large net losses. They appeared to be a failing company on the income statement, but investors knew that there was more to their story and continued to value the company highly. Uber turned a profit in 2018 and proved that previous income statements are a piece of the puzzle but that they do not show the entire story or value of the company. Therefore, in my career I will weigh these two alternatives to consider the value of an organization. Further, as a future certified public accountant, I will be placed at the crux of this debate. On one hand, my duty as an accountant is to ensure that a business reported financials give the most genuine image of the company to investors. It will be my job to ensure that the best methods are being used to ensure the accuracy and reliability of the statements. On the other hand, it will also be my job to make sure that

companies adhere to the current standards that are in place. Regardless of my views and advocacy of alternative methods, as an account I will be held responsible for the current standards until FASB ultimately decides to alter the landscape of the accounting process. This article changes the way I view the process and need for accountants; however, it will not change the way that I audit an organization. I will audit and report financial statements with accuracy towards the current standards until they are changed.

The Honor Code:

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

Signed *Charles William Boatright*

Case Study #12: Google
Dr. Dickinson Accy 420

Will Boatright
April 30, 2019

Introduction

This case examines the non-GAAP financial results of Google in contrast to their GAAP results. The crux of this case hinges on the importance of non-GAAP financial results and their relevance for investors. Companies often disclose these figures on their financial reports with explanations for their relevance. One time and non-cash expenses are added back to net income to show investors a more accurate image of their results from operations. These results give investors a better picture of the future of the firm because non cash expenses such as depreciation do not affect the available cash for investments of the company. In addition, one-time charges such as restructuring costs are irregular and are not relevant for investors decisions. The flaw of these amendments to the income statement is that they can be easily manipulated, and they are not consistently applied to all businesses. The methods used from company to company to report non-GAAP earnings varies, so it is impossible to compare the results among the industry. These figures can be misleading as well. For example, if a company adds back a fine because it is a one-time expense, this is misleading because the fine could impact future earnings of the business. The fine could expose an illegal practice that the company has been using that is essential to their operations. Further, the fine could damage consumer opinions of the company's ethics which would damage the long-term value of the company. As an auditor it is our job to ensure that financial statements are prepared correctly so that potential investors and creditors can make educated decisions. Therefore, non-GAAP financials are an important issue for auditors to consider because the have the capability to show investors a more accurate image of the company. However, these figures erode

consistency and do not adhere to GAAP standards. It is important for the accounting community to analyze the importance of this issue and continue to ensure that financial statements are accurate resources for investors to use.

H. Read the excerpts of the press release titled "Google Announces Fourth Quarter and Fiscal Year 2013 Results" and review Google's operating performance reported in the statements of income accompanying the press release.

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

The differences between the GAAP reported income and non-GAAP reported income can be found on page thirteen of the report. In quarter four of 2013, Google began with their GAAP net income of $3.376 billion and added back the following items: stock-based compensation of $902 million, restructuring charges of $15 million, their respective tax allocations of $191 million and $11 million respectively, and a net loss of $5 million from discontinued operations. Google thus reported a non-GAAP net income of $4.096 billion on their financial reports for the fourth quarter of 2013. I agree with the alterations made to stock based compensation and restructuring costs. Stock based compensation is a non cash expense that has relatively no effect on the profitability or state of the company.

In addition, stock-based compensation is added to equity so potential creditors are not affected by this amount. This figure is important because it reoccurs consistently, and different companies report this non-GAAP figure differently. Therefore, it is crucial that they report stock-based compensation on their income statement, but it is not relevant to creditors and it does not influence the profitability of the company in future periods. Therefore, it is acceptable for Google to show these items separately against their results from operations. Restructuring costs should be added back for non-GAAP purposes as well. This is a one-time expense that has no effect on the earnings of the period. Investors should disregard this expense because restructuring is a one-time strategic plan that Google anticipates creating earnings from. Rather, investors should analyze opinions debating whether the restructure will translate into value in the future. Therefore, it is appropriate for investors to add this expense back to determine the current value of the business. Restructuring costs are important and investors should analyze the restructuring of the business. However, the expense should not be deducted from the value of the company because Google plans to use the new structure to enhance long term earnings. However, one-time charges must be handled on a case to case basis to determine their appropriateness on non-GAAP financial statements. One-time charges such as litigation fees or fines can be used to manipulate earnings for investors using non-GAAP measurements to try to show an indication of success. For example, companies could be more willing to take on unethical or illegal activities because they will add back the associated costs of one-time fines to project non-GAAP income. While these costs occur once, they may have a serious impact on future profitability of the company.

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

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

Google's earnings increased 17% from 2012 to 2013. In contrast, the stock price for Google increased 37% over the year. This shows that investors believed that Google's value was increasing at a rate well higher than their earnings. Investors were using non-GAAP measures or balance sheet analysis to determine the value of Google opposed to the income earnings during the period.

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

Google's stock price appreciated at a similar rate to other companies on the NASDAQ for the first three quarters of 2013. However, Google's stock shot up during the fourth quarter while the NASDAQ average showed slow growth consistent with the first three quarters.

iii. Based on the stock market chart, did the market perceive the earnings news in Google's press release dated January 30, 2014, as "good news" or "bad news"? Note: the press release was made available after the close of trading for the day.

The market responded uniquely to the 2013 earnings press release. The stock price dropped sharply on January 31, 2014. This shows that the immediate response to the press release was negative. The sharp drop in price immediately after the report shows that the drop was directly related to the earnings news. However, the stock price quickly climbed back above the original value before the earnings report in the next two weeks. This shows that the report had an overall positive affect on the stock price. The immediate drop shows that the market was initially hesitant about earnings but eventually saw truth in the earnings statements.

J. 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?

Google reported higher revenues than the analyst had expected. Thomson Reuters projected $16.8 billion of revenue and Google actually recorded $16.9 billion. The article mention's that net income in the fourth quarter was 17% higher than the year before. The article does not state if net income in the quarter was higher or lower than expected. Rather, the article discloses the expected versus actual non-GAAP earnings per share. This shows that The Wall Street Journal and their financial audience are not concerned with GAAP bottom line per se. The investment community is interested in results from operations and cash flows. Net income must be adjusted to show these figures. The article also goes into great depth explaining Google's revenue streams. The fourth quarter results are consistent with the market reaction. While non-GAAP earnings per share were lower than expected, investors are excited about the increase in revenue and the strategic restructuring of the business.

ii. <u>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?</u>

The article suggests that investors are pleased with Google's decision to streamline the business. This is a representation of the restructuring costs that were added back for non-GAAP measures. The second highlight for investors was Google's dramatic increase in other revenues and gains. This largely stems from Android app sales. The market is responding positively to this because it shows that Google will stay competitive in the smart phone market that is taking over the tech industry. Finally, investors were pleased

that Google dropped their dead weight in Motorola. This increased their bottom line and opened up enough cash flow to allow Google to record their largest investment in capital expenditures ever. However, there are a few points that investors should be concerned with. Google is receiving 11% less per click than the year before. This shows investors that Google might not be able to keep up with their previous efficiency and that consumers are moving away from their product. More importantly, investors should be concerned with the consumer trend towards smart phones. Hindsight is twenty-twenty, but it is essential that Google adapts and invests further in technology related to smart phones to ensure that earnings continue to increase.

The Honor Code:

“On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this case study.”

Signed *Charles William Boatright*