Accounting Questions and Answers – Advanced (15 Questions)

35. How is GAAP accounting different from tax accounting?

1. GAAP is accrual based but tax is cash based
2. GAAP uses straight-line depreciation or a few other methods whereas tax accounting is different (accelerated depreciation)
3. GAAP is more complex and more accurately tracks assets/liabilities whereas tax accounting is only concerned with rev/expenses in the current period and what income tax you owe
4. Asset writeups/writedowns are reflected in GAAP accounting but not in tax accounting

36. What are deferred tax assets/liabilities and how do they arise?

They arise bc of temporary differences between what a company can deduct for cash tax purposes vs what they can deduct for book tax purposes

Deferred tax liabilities arise when you have a tax expense on the IS but haven't actually paid that tax in cash yet. Deferred tax assets arise when you pay taxes in cash but haven't expensed them on the IS yet

They're most common with asset writeups and write-downs in M&A deals – an asset writeup will produce a deferred tax liability while a write-down will produce a deferred tax asset

37. Walk me through how you create a revenue model for a company

There are two ways you could do this: a bottoms-up build and a top-down build.

Bottoms up: Start with individual products/customers, estimate the avg sale value of customer value, and then the growth rate in sales and sale values to tie everything together

Top down: start with he big picture metrics like overall market size, then estimate the company's market share and how that will change in coming years, and multiply to get to their revenue

Of these two methods, bottoms-up is more common and is taken more seriously because estimating "big picture" numbers is almost impossible

38. Walk me through how you create an expense model for a company

To do a true bottoms-up build, you start with each different department of a company, the number of employees in each, the average salary, bonuses, and benefits, and then make assumptions on those going forward

Usually you assume that the number of employees is tied to revenue, and then you assume growth rates for salary, bonuses, benefits, and other metrics

COGS should be tied directly to Revenue and each “unit” produced should incur an expense

Other items such as rent, capex, and miscellaneous expenses are either linked to the company’s internal plans for building expansion plans (if they have them), or to Revenue for a more simple model

39. Let’s say we’re trying to create these models but don’t have enough information or the company doesn’t tell us enough in its filings – what do we do?

Simplify, assume simple growth rate and expense margin

Use estimates. For the rev if you don’t have enough information to look at separate product lines or divisions of the company, you can just assume a simple growth rate into future years

For the expenses, if you don’t have employee-level information then you can just assume that major expenses like sg&a are a percent of revenue and carry that assumption forward

40. Walk me through the major items in shareholders’ equity

Additional Paid in Capital (stock based compensation, exercised stock options, value above par in an IPO), Accumulated Other Comprehensive Income

Common items include:

1. Common stock: simply the par value of however much stock the company has issued
2. Retained earnings: how much of the company’s NI it has “saved up” over time
3. Additional paid in capital: this keeps track of how much stock-based compensation has been issued and how much new stock employees exercising options have created. It also includes how much over par value a company raises in and IPO or other equity offering
4. Treasury stock: The dollar amount of shares that the company has bought back
5. Accumulated other comprehensive income: this is a “catch all” that includes other items that don’t fit anywhere else, like the effect of foreign currency exchange rates changing

41. Walk me through what flows into retained earnings

Retained earnings = old retained earnings balance + NI – dividends issued

If you're calculating Retained Earnings for the current year, take last year's Retained Earnings number, add this year's Net Income, and subtract however much the company paid out in dividends.

42. Walk me through what flows into additional paid in capital (APIC)

APIC = Old APIC + stock based compensation + value of stock created by option exercises

Take the balance from last year, add this year's stock-based compensation number, and then add in the value of new stock created by employees exercising options this year

43. What is the statement of shareholders' equity and why do we use it?

Just a statement that shows the items in shareholders' equity, retained earnings (old value + NI – dividends), common stock, treasury stock, additional paid in capital (stock based compensation + exercised employee options + value over par in an IPO/other offering), accumulated other comprehensive income

This statement shows everything we went through above – the major items that comprise shareholders' equity, and how we arrive at each of them using the numbers elsewhere in the statement

You don't use it too much, but it can be helpful for analyzing companies with unusual stock-based compensation and stock option situations

44. What are examples of non-recurring charges we need to add back to a company's EBIT/EBITDA when looking at its financial statements?

Restructuring charges, goodwill impairment, asset write-downs, bad debt expenses, legal expenses, disaster expenses, change in accounting procedures

Note that to be and add-back or non-recurring charge for EBIDTA/EBIT purposes, it needs to affect operating income on IS. So if you have one of these charges "below the line" then you don't add it back for the EBITDA/EBIT calculation

Also note that you do add back Depreciation, Amortization, and sometimes Stock-Based Compensation for EBITDA/EBIT, but that these are not "non-recurring charges" because all companies have them every year – these are just non-cash charges

45. How do you project BS items like AR and accrued expenses in a 3-statement model?

Simple percentages

Normally you make very simple assumptions and assume these are percentages of rev, operating expenses, or COGS

Examples are AR from % of rev, deferred rev from % of rev, AP from % of COGS, accrued expenses from % of operating expenses or sg&a

Then you either carry the same percentages across in future years or assume slight changes depending on the company

46. How should you project depreciation and capex?

The simple way: as a percentage of rev or previous pp&e balance

The more complex way: create a pp&e schedule that splits out different assets by their useful lives, assumes straight-line depreciation over each asset's useful life, and then assumes capex based on what the company has invested historically

47. How do Net Operating Losses (NOLs) affect a company's 3 statements?

"Quick and dirty" way it to reduce the taxable income by the portion of the NOLs that you can use each year, apply the same tax rate, and then subtract that new tax number from your old pretax income number (which should stay the same)

The way you should do this: create a book vs cash tax schedule where you calculate the taxable income based on NOLs, and then look at what you would pay in taxes without the NOLs. Then book the difference as an increase to the deferred tax liability on the BS

This method reflects the fact that you're saving on cash flow – since the DTL, a liability, is rising – but correctly separates the NOL impact into book vs cash taxes

48. What's the difference between capital leases and operating leases?

Operating leases are used for short-term leasing of equipment and property, and do not involve ownership of anything. Operating lease expenses show up as operating expenses on IS

Capital leases are used for longer-term items and give the lessee ownership rights; they depreciate and incur interest payments and are counted as debt

A lease is a capital lease if any of these 4 conditions are true:

1. If there's a transfer of ownership at the end of the term
2. If there's an option to purchase the asset at a bargain price at the end of the term
3. If the term of the lease is greater than 75% of the useful life of the asset

4. If the present value of the lease payments is greater than 90% of the asset's fair market value

49. Why would the depreciation and amortization number on the IS be different from what's on the CFS?

This happens if depreciation and amortization is embedded in other IS line items. When this happens, you need to use the CFS number to arrive at EBITDA bc otherwise your undercounting D&A