

Accounting Questions and Answers – Basic (34 questions)

1. Walk me through the 3 financial statements.

IBC

The three financial statements are the Income Statement, Balance Sheet and Cash Flow Statement.

The Income Statement gives the company's revenue and expenses and goes down to Net Income the final line on the statement

The balance sheet shows the company's assets (cash, inventory, pp&e), liabilities (debt, accounts payable) and shareholders' equity. Rem assets = equity + liabilities

The cash flow statement begins with net income adjusts for non cash expenses (like depreciation) and working capital (assets – liabilities) changes. And then lists cash flow from investing and financing activities at the end the company's net change in cash

2. Can you give examples of major line items on each of the financial statements?

Income Statement: Revenue, COGS, SG&A, operating income (EBIT), pretax income (EBT), net income

Balance Sheet: Cash, AR, inventory, pp&e, AP, accrued expenses, debt, shareholders' equity

Cash Flow Statement: Net income, depreciation and amortization, stock based compensation, changes in operating assets and liabilities, cash flow from operations, capex, cash flow from investing, sale/purchase of securities, dividends issued, cash flow from financing

3. How do the 3 statements link together?

NI from the IS flows into shareholders' equity (as retained earnings) on the BS and into the top line of the CFS (into cash flow from operating activities, as NI)

Changes to balance sheet items (NI) appear as working capital changes on the CFS.

Investing and financing activities affect BS items like pp&e, debt, and shareholders' equity.

Cash and shareholders' equity items on BS can act as plugs to balance activity, with cash inflow on final line of CFS

4. If I only had 1 statement to review the overall health of a company, which statement would I use and why?

You would use the CFS because it gives a true picture of how much cash the company is actually generating, independent of the non-cash expenses there may be. Cash flow is the most important metric to analyze the overall financial health of a business.

5. Let's say I could only look at 2 statements to assess a company's prospects – which 2 would I use and why?

IB

You would pick the IS and BS because you can create the CFS from both of these (assuming ofc that you have before and after versions of the BS that correspond to the same period the IS tracks). You can't do this vice versa (because CFS doesn't track revenue and expense workflows)

6. Walk me through how depreciation going up by \$10 would affect the statements.

These ones ICB, assume tax rate of 40%

Or that a company misestimates depreciation and increases it to more accurately reflect pp&e

Depreciation could also increase with the purchase of a new asset but in this question it just states that depreciation increases and no other accounts

IS: Operating income (EBIT) would decline by \$10, and assuming a 40% tax rate, NI would go down by \$6 (taxable income decreases by \$10 but saves \$4 in tax expense) (new income = old income – 40% * 10).

CFS: NI again goes down by \$6 but the \$10 depreciation is a non-cash expense that gets added back, so CF from operations increases by \$4. No other changes so overall net change in cash increases by \$4

BS: pp&e goes down by \$10 on assets side, and cash is again up \$4 from the changes on the CFS.

This is not a writeup it's just an increase in depreciation nothing else

Overall, assets is down by \$6. Since NI also fell by \$6, shareholders' equity on the liabilities and shareholders' equity side of the accounting equation is down by \$6 and it balances.

For this type of question, go in IS, CFS, then BS order so that you can check that the BS balances.

Rem that as an asset increases, your cash flow decreases, whereas a liability that increases increases your cash flow

IS NI = revenue – COGS – operating expenses – D&A – interest – taxes

Net Cash Flow (change in cash) = cash flow from operations CFO (NI + non cash expenses (like D&A and stock compensation) - change in operating working capital (change in current assets excluding cash and cash equivalents (like AR and inventory) – change in current liabilities excluding debt (like AP and accrued expenses)) + cash flow from investing CFI (proceeds from sale of assets - capex + other investing activities) + cash flow from financing CFF (change in debt + equity issuances – dividends paid - stock buybacks)

BS assets (cash + PP&E + AR + inventory) = liabilities (current liabilities (debt + AP + accrued expenses + deferred revenue) + non-current liabilities (debt + lease + pension + deferred tax)) + shareholders' equity (common stock + retained earnings (NI – financing costs like dividends) + treasury stock)

7. If depreciation is a non-cash expense, why does it affect the cash balance?

Although depreciation is a non-cash expense, it is tax-deductible. Since taxes are a cash expense, depreciation affects cash by reducing the amount of taxes you pay.

8. Where does depreciation usually show up on the IS?

It could be a separate line item, or it could be embedded in COGS or operating expenses – every company does it differently. Note that the end result for accounting questions is the same. Depreciation always reduces pre-tax income.

9. What happens when accrued compensation goes up by \$10?

Accrued compensation is a wages expense, not an account receivable asset

For this question, confirm that the accrued compensation is now being recognized as an expense (as opposed to just changing non-accrued to accrued compensation).

Assuming so, operating expenses on the IS increases by \$10, pre tax income falls by \$10, and NI falls by \$6 (assuming a 40% tax rate)

On the CFS, NI again is down \$6 and accrued compensation will increase cash flow by \$10, so overall cash flow from operations is up by \$4 and the net change in cash at the bottom is up by \$4

On the BS, cash is up by \$4 as a result, so assets are up by \$4. On the liabilities and equity side, accrued compensation is a liability so liabilities are up by \$10 and retained earnings are down by \$6 due to NI, so both sides balance

Always finish these questions by confirming that both sides balance

10. What happens when inventory goes up by \$10, assuming you pay for it with cash?

No changes to IS.

On CFS, inventory is an asset so that decreases your cash flow from operations – it goes down by \$10, as does the net change in cash at the bottom

On BS, under assets, inventory is up \$10 but cash is down \$10, so the changes cancel out and the accounting equation balances

11. Why is the IS not affected by changes in inventory?

Common interview mistake – incorrectly stating that working capital changes show up on the IS

For inventory, the expense is only recorded when the goods associated with it are sold. So, if it's just sitting in a warehouse, it does not count as COGS or operating expense until the company manufactures it into a product and sells it

Because the expense is only recorded (as COGS) when the inventory is sold (accrual-based accounting)

12. Let's say Apple is buying \$100 worth of new iPad factories with debt. How are all 3 statements affected at the start of "year 1", before anything else happens?

At the start of year 1, before anything else has happened, there would be no changes on Apple's IS (yet)

On CFS the additional investment in factories would show up under cf from investing as a net reduction in cf (so cf is down by \$100 so far). And the additional \$100 of debt raised would show up as an addition to cf, canceling out the investment activity. So the cash number stays the same.

On BS there is now an additional \$100 worth of factories in the pp&e line, so pp&e is up by \$100 and assets is therefore up by \$100. On the other side, debt is up by \$100 as well so the equation balances

13. Now fast forward to the start of year 2. Assume the debt is high-yield so no principal is paid off, and assume an interest rate of 10%. Also assume the factories depreciate at a rate of 10% per year. What happens?

After a year has passed, Apple must pay interest expense and must record the depreciation.

IS operating income would decrease by \$10 due to the 10% depreciation charge each year, and the \$10 in additional interest expense would decrease the pre-tax income by \$20 altogether (\$10 from depreciation and \$10 from interest expense). Assuming a tax rate of 40%, NI would fall by \$12

CFS, NI at the top line is again down \$12. Dp is a non-cash expense, so you would add it back which results in cf operations down by \$2. That's the only change on the cf statement, so overall cf is down by \$2.

BS, under assets cash is again down by \$2 and pp&e is down by \$10 due to the depreciation, so overall assets are down by \$12. On other side of equation, NI was down by \$12 so shareholders' equity is down by \$12 and both sides balance.

Rem that the debt under liabilities doesn't change since we've assumed that none of the debt is actually paid back

14. At the start of Year 3, the factories all break down and the value of the equipment is written down to \$0. The loan must also be paid back now. Walk me through the 3 statements.

A writedown is a noncash expense

After 2 years, the value of the factories is now \$80 if we go with the 10% dp per year assumption. It's this that will be written in the 3 statements.

First, on IS, the \$80 write-down shows up in the pre-tax income line (this could be under SG&A or a separate "impairment" line item). With a 40% tax rate, NI decreases by \$48

On CFS, NI is down by \$48 but the write-down is a non-cash expense, so we add it back – and therefore cf from operations increases by \$32

There are no changes under cf from investing, but under cf from financing there is a \$100 charge for the loan payback – so cf from investing falls by \$100

Overall, net change in cash falls by \$68

On BS, cash is now down by \$68 and pp&e is down by \$80, so assets have decreased by \$148 altogether

On the other side, debt is down \$100 since it was paid off, and since NI was down by \$48, shareholders' equity is down by \$48 as well. Altogether, equity and liabilities are down by \$148 and the equation balances

15. Now let's look at a different scenario and assume Apple is ordering \$10 of additional iPad inventory, using cash on hand. They order the inventory, but they have not manufactured or sold anything yet – what happens to the 3 statements?

No changes to IS

CFS inventory is up 10 so cf operations decreases by 10. There are no further changes so overall cash is down by 10

Cash is usually excluded from NWC in financial modeling, so actual NWC is the same but CFO is still down by 10

BS inventory is up 10 and cash is down by 10 so the assets number stays the same and the BS remains in balance

16. Now let's say they sell the iPads for revenue of \$20, at a cost of \$10. Walk me through the 3 statements under this scenario

IS rev is up by 20 and COGS is up by 10 so gross profit is up by 10 and operating income is up by 10 as well. Assuming a 40% tax rate, NI is up by 6

CFS NI again up by 6 and inventory has decreased by 10 (bc we just manufactured the inventory into real iPads), which is a net addition to cf, so cf from ops is up by 16 overall

These are the only changes on CFS, so net change in cash is up by \$16

BS cash is up by \$16 and inventory is down by 10 so assets is up by 6 overall

On other side NI was up by 6 so shareholders' equity is up by 6 and both sides balance

17. Can you ever end up with negative shareholders' equity? What does that mean?

In retained earnings, from dividend recaps or consistently negative NI

Yes. It is common to see this in 2 scenarios:

1. LBOs with dividend recapitalizations – it means that the owner of the company has taken out a large portion of its equity (usually in the form of cash) which can sometimes turn the number negative

2. Also if the company has been losing money consistently and therefore has a declining retained earnings balance, which is a portion of the shareholders' equity

It doesn't mean anything in particular, but it can be a cause for concern and possibly show that the company is struggling (in the second case)

18. What is working capital? How is it used?

Working capital = current assets – current liabilities

If it's positive it means that a company can pay off its short-term liabilities with its short-term assets. It is often presented as a financial metric and its magnitude and sign tells you whether or not a company is "sound"

Bankers look at operating working capital more commonly in models and that is defined as (current assets – cash and cash equivalents) - (current liabilities – debt)

The point of operating working capital is to exclude items that relate to a company's financing activities – cash and debt – from the calculation

19. What does negative working capital mean? Is that a bad sign?

Not necessarily. It depends on the type of company and the specific situation – here are a few different things it could mean:

1. Some companies with subscriptions or longer-term contracts often have negative working capital bc high deferred revenue balances
2. Retail and restaurant companies like amazon, Walmart, mcdonalds often have negative working capital bc customers pay upfront, so they can use the cash generated to pay off their AP rather than keeping a large cash balance on-hand. This can be a sign of business efficiency
3. In other cases, negative working capital could point to financial trouble or possible bankruptcy (like when customers don't pay quickly and upfront and the company is carrying a high debt balance)

20. Recently, banks have been writing down their assets and taking huge quarterly losses. Walk me through what happens on the 3 statements when there's a write-down of 100

Writedowns are non-cash operating expenses (so they affect pretax income, like D&A)

IS the 100 writedown shows up in the pretax income line. With a 40% tax rate, NI declines by 60

CFS NI again down by 60 but the writedown is a noncash expense so we add it back, and therefore cf ops increases by 40. Overall net change in cash rises by 40

BS cash is again up by 40 and assets down by 100. Overall, the assets side is down by 60

On other side, since NI down by 60, equity is down by 60. Both sides balance.

21. Walk me through a 100 bailout of a company and how it affects the 3 statements

First, confirm what type of bailout this is: debt? Equity? A combination? The most common scenario here is an equity investment from the government. In such case:

IS no changes

CFS cf from financing goes up 100 to reflect government's investment. Net change in cash is up 100

BS cash again up 100 so assets are up 100. On other side, equity up 100 to make the accounting equation balance

22. Walk me through a 100 write down of debt, as an owed debt, a liability, on a company's BS and how it would affect the 3 statements

This is counterintuitive. When a liability is written down you record it as a gain on the IS (while asset write-down is a loss) so pre-tax income goes up by 100. Assuming 40% tax rate, NI is up 60

CFS NI again up 60 but we need to subtract that debt write-down, so cf ops is down by 40 and net change in cash is down by 40

BS cash again is down by 40 so assets are down by 40. On other side, debt is down by 100 but equity is up by 60 so liabilities and equity is down by 40 and the equation balances

23. When would a company collect cash from a customer and not record it as revenue?

Three examples come to mind, basically periodic payment collection:

1. Web-based subscription software
2. Cell phone carriers that sell annual contracts
3. Magazine publishers that sell subscriptions

Companies that agree to services in the future often collect cash upfront to ensure stable revenue – this makes investors happy bc they can better predict a company's performance.

Per the rules of accounting, you only record revenue when you actually perform the services – so the company would not record everything as revenue right away

Companies would record this as deferred revenue instead

24. If cash collected is not recorded as revenue, what happens to it?

Usually it goes into the deferred revenue balance on BS under liabilities

Over time, as the services are performed, the deferred revenue balance becomes real revenue on the IS and the deferred revenue balance decreases

25. What's the difference between AR and deferred revenue?

AR has not yet been collected in cash from customers, whereas deferred revenue has been. AR represents how much revenue the company is waiting on, whereas deferred revenue represents how much it has already collected in cash but is waiting to record as revenue. AR not there yet deferred revenue already there

26. How long does it usually take for a company to collect its AR balance?

Generally the AR days are in the 30-60 day range, though it's higher for companies selling high-end items and might be lower for smaller, lower transaction value companies

27. What's the difference between cash-based and accrual accounting?

Cash-based accounting recognizes rev and expenses when cash is actually received or paid out. Accrual based accounting recognizes revenue when collection is reasonably certain (like after a customer has ordered the product) and recognizes expenses when they are incurred rather than when they are paid out in cash

Most large companies use accrual based accounting because credit is prevalent now. Very small businesses may use cash-based accounting to simplify their financial statements

28. Let's say a customer pays for a TV with a credit card. What would this look like under cash-based vs accrual accounting?

In cash-based accounting, the rev would not show up until the company charges the customer's credit card, receives authorization, and deposits the funds in its bank account – at which point it would show up as both revenue on the IS and cash on the BS

Cash based revenue and expense are recorded when payment from bank is received

Accrual based revenue and expense are recorded when item is sold

In accrual based accounting, it would show up as rev right away but instead of appearing in cash on BS, it would go into AR at first. Then, once the cash is actually deposited in the company's bank account, it would turn into cash

COGS recorded when revenue is recorded in both methods

29. How do you decide when to capitalize rather than expense a purchase?

If the asset has a useful life of over 1 year, it is capitalized (put on BS rather than as an expense on IS). Then it's depreciated (tangible assets) or amortized (intangible assets) over a certain number of years

Purchases like factories, equipment and land all last longer than a year and therefore show up on the BS. Employee salaries and COGS only cover a short period of operations and therefore show up on the IS as normal expenses instead

30. Why do companies report both GAAP and non-GAAP ("pro forma") earnings?

Expenses like amortization of intangibles, stock based compensation, and deferred revenue writedowns are included in GAAP, that can dilute NI. Company can get more accurate figures with Non-GAAP, and as result Non-GAAP earnings are almost always higher

Many companies have "non-cash" charges such as amortization of intangibles, stock based compensation, and deferred revenue write down in their IS. As a result, some argue that IS under GAAP no longer reflect how profitable most companies truly are. Non-GAAP earnings are almost always higher because these expenses are excluded.

31. A company has had positive EBITDA for the past 10 years, but it recently went bankrupt. How could this happen?

Several possibilities:

1. The company is spending too much on capex – these are not reflected at all in EBITDA – but it could still be cash-flow negative
2. The company has high interest expense and is no longer able to afford its debt
3. The company's debt all matures on one date and is unable to refinance it due to a "credit crunch", and runs out of cash completely when paying back the debt
4. It has significant one-time charges (from litigation, for example) and those are high enough to bankrupt the company

Rem EBITDA excludes investment in (and depreciation of) long-term assets, interest and one-time charges – and all of these could end up bankrupting the company

32. Normally Goodwill remains constant on the BS – why would it be impaired and what does Goodwill Impairment mean?

Goodwill: An intangible asset (like brand reputation, customer loyalty, etc.) that arises when one company purchases another. This can cause the buyer to pay above the fair market value to acquire the seller (with the excess, intangible goodwill value)

This usually happens when a company has been acquired and the acquirer re-assesses its intangible assets (such as customers, brand, and IP) and finds that they are worth significantly less than they originally thought

It often happens in acquisitions where the buyer overpaid for the seller and can result in a large net loss on IS

It can also happen when a company discontinues part of its operations and must impair the associated goodwill

33. Under what circumstance would Goodwill increase?

Technically Goodwill can increase if the company reassesses its value and finds that it is worth more, but that is rare. What usually happens is one of two scenarios:

1. The company gets acquired or bought out and Goodwill changes as a result, since it's an accounting "plug" for the purchase price in an acquisition
2. The company acquires another company and pays more than what its assets are worth – this is then reflected in the Goodwill number

34. What's the difference between LIFO and FIFO? Walk me through an example of how they differ.

Trade offs for each method. FIFO better optics (higher reported earnings) but more real value of tax payments (time value of money) but LIFO worse optics now but more value saved. Under GAAP you can choose either apparently

First, note that this question does not apply to you if you're outside the US as IFRS (International Financial Reporting Standards) does not permit the use of LIFO. But you may want to read this anyway because it's good to know in case you ever work with US-based companies.

LIFO stands for "Last-In, First-Out" and FIFO stands for "First-In, First-Out" – they are 2 different ways of recording the value of inventory and COGS.

With LIFO, you use the value of the most recent inventory additions for COGS, but with FIFO you use the value of the oldest inventory additions for COGS. Here's an example: let's say your starting inventory balance is \$100 (10 units valued at \$10 each). You add 10 units

each quarter for \$12 each in Q1, \$15 each in Q2, \$17 each in Q3, and \$20 each in Q4, so that the total is \$120 in Q1, \$150 in Q2, \$170 in Q3, and \$200 in Q4.

You sell 40 of these units throughout the year for \$30 each. In both LIFO and FIFO, you record $40 * \$30$ or \$1,200 for the annual revenue.

The difference is that in LIFO, you would use the 40 most recent inventory purchase values – $\$120 + \$150 + \$170 + \200 – for the Cost of Goods Sold, whereas in FIFO you would use the 40 oldest inventory values – $\$100 + \$120 + \$150 + \170 – for COGS.

As a result, the LIFO COGS would be \$640 and FIFO COGS would be \$540, so LIFO would also have lower Pre-Tax Income and Net Income. The ending inventory value would be \$100 higher under FIFO and \$100 lower under LIFO.

In general if inventory is getting more expensive to purchase, LIFO will produce higher values for COGS and lower ending inventory values and vice versa if inventory is getting cheaper to purchase.

Assuming increasing cost per unit inventory, FIFO reports higher pretax income but also requires a higher tax payment than LIFO. Because of this LIFO is better in an inflationary environment because it defers tax payments and it's better to have money now than later (time value of money). Know that your actual money is the same just your reported income is different. But FIFO can create better optics

| INCOME STATEMENT | | | | |
|---|--------------|--------------|--------------|--------------|
| | 20X1 | 20X2 | 20X3 | 20X4 |
| Revenue | 1,331 | 1,464 | 1,611 | 1,772 |
| Cost of Goods Sold | 799 | 878 | 966 | 1,063 |
| Gross Profit | 532 | 586 | 644 | 709 |
| Operating Expenses (SG&A) | 200 | 220 | 242 | 266 |
| Operating Income (EBIT) | 333 | 366 | 403 | 443 |
| Interest Expense | 43 | 38 | 33 | 28 |
| Pretax Income | 290 | 329 | 370 | 415 |
| Income Tax Expense | 102 | 115 | 130 | 145 |
| Net Income | 189 | 214 | 241 | 270 |
| BALANCE SHEET | | | | |
| | 20X1 | 20X2 | 20X3 | 20X4 |
| Cash | 478 | 627 | 809 | 1,026 |
| Accounts Receivable | 109 | 120 | 132 | 146 |
| Inventory | 131 | 144 | 159 | 175 |
| Total Current Assets | 718 | 892 | 1,100 | 1,346 |
| Property Plant & Equipment (PP&E) | 840 | 837 | 827 | 808 |
| TOTAL ASSETS | 1,559 | 1,729 | 1,927 | 2,155 |
| Accounts Payable | 66 | 72 | 79 | 87 |
| Current Portion on Long Term Debt | 50 | 50 | 50 | 50 |
| Total Current Liabilities | 116 | 122 | 129 | 137 |
| Long Term Debt | 400 | 350 | 300 | 250 |
| TOTAL LIABILITIES | 516 | 472 | 429 | 387 |
| Common Stock | 100 | 100 | 100 | 100 |
| Retained Earnings | 943 | 1,157 | 1,397 | 1,667 |
| TOTAL EQUITY | 1,043 | 1,257 | 1,497 | 1,767 |
| TOTAL LIABILITIES & EQUITY | 1,559 | 1,729 | 1,927 | 2,155 |
| Check | 0.0 | 0.0 | 0.0 | 0.0 |
| CASH FLOW STATEMENT | | | | |
| | 20X1 | 20X2 | 20X3 | 20X4 |
| CASH FLOW FROM OPERATING ACTIVITIES | | | | |
| Net Income | | 214 | 241 | 270 |
| Add Back Non-Cash Items | | | | |
| Depreciation | | 73 | 81 | 89 |
| Amortization | | 0 | 0 | 0 |
| Changes in Working Capital | | | | |
| Accounts Receivable | | (11) | (12) | (13) |
| Inventory | | (13) | (14) | (16) |
| Accounts Payable | | 7 | 7 | 8 |
| Net Cash Provided by Operating Activities | | 269 | 302 | 337 |
| CASH FLOW FROM INVESTING ACTIVITIES | | | | |
| Capital Expenditures - Purchase of PP&E | | (70) | (70) | (70) |
| Net Cash Used in Investing Activities | | (70) | (70) | (70) |
| CASH FLOW FROM FINANCING ACTIVITIES | | | | |
| Revolving Credit Facility | | 0 | 0 | 0 |
| Long Term Debt (Current Portion) | | (50) | (50) | (50) |
| Net Cash Provided by (Used in) Fnce Activities | | (50) | (50) | (50) |
| Net Cash Flow | | 149 | 182 | 217 |