Financial Modeling Fundamentals – Module 03 Accounting Interview Questions – Quiz Questions

1. **On the first day of the year, a company pays $120 for insurance coverage for the entire year, which reduces Cash by $120 and increases Prepaid Expenses by $120 at that instant.**

   Six months into the year, how have Net Income, Cash, and Prepaid Expenses on the financial statements changed?

   Assume that ONLY the insurance expense has impacted the statements and that there have been no other changes. Also assume a 40% tax rate.

   a. Net Income INCREASES by $36; Cash DECREASES by $24; Prepaid Expenses INCREASES by $60.

   b. Net Income does not change; Cash INCREASES by $60; Prepaid Expenses DECREASES by $60.

   c. Net Income DECREASES by $60; Cash INCREASES by $60; Prepaid Expenses DECREASES by $60.

   d. Net Income DECREASES by $36; Cash INCREASES by $24; Prepaid Expenses DECREASES by $60.

2. **A company has 1 million shares outstanding at a market price of $10.00 per share. It is set to earn $9 million in net income for the next year. The company can repurchase 100,000 of its shares at a discount, for $5.50 per share, at the very beginning of this year.**

   After the share repurchase, what is the company's projected earnings per share (EPS) for the year? Assume that the company is NOT earning anything on the cash it uses for the share repurchase.

   a. $9.39.

   b. $10.00.

   c. $9.00.

   d. $8.89.

3. **A company issues $500 worth of debt with an annual interest rate of 10% and principal repayment of 20% each year. Initially, Cash on the Balance Sheet increases by $500 and Debt increases by $500 on the other side to balance it.**

   Exactly *one year* after the debt has been issued, how do the financial statements change? Assume a tax rate of 40%.

   Also assume that the interest expense is based on the beginning debt balance (i.e., do NOT average the beginning and ending balances).

   a. Debt DECREASES by $100; Net Income DECREASES by $30; Cash DECREASES by $130.

   b. Debt DECREASES by $100; Net Income DECREASES by $130; Cash DECREASES by $130.

   c. Debt DECREASES by $100; Net Income does not change; Cash DECREASES by $100.

   d. Debt DECREASES by $100; Net Income DECREASES by $30; Cash DECREASES by $100.

4. **A company purchases an asset with a useful life of 5 years and no salvage value for $100. The company depreciates this asset using the straight-line method, where the annual depreciation expense equals 20% of the initial purchase price.**

   The company then sells the asset for $60 at the END of Year 3. The company has a tax rate of 40%.

   How does this asset sale change the company's financial statements compared to what they looked like *immediately before* the company sold it?

   a. Net Income INCREASES by $12; Cash INCREASES by $52; PP&E DECREASES by $40.

   b. Net Income does not change; Cash INCREASES by $40; PP&E DECREASES by $40.

   c. Net Income INCREASES by $36; Cash INCREASES by $36; PP&E DECREASES by $60.

   d. Net Income INCREASES by $12; Cash INCREASES by $52; PP&E DECREASES by $60.

5. **Which of the following statements are TRUE regarding the impact of a dividend issuance compared to a share repurchase on the three financial statements?**

   a. Both a dividend issuance and a share repurchase will change the company's Earnings per Share (EPS), since dividends affect earnings and repurchased shares affect the company's share count.

   b. A share repurchase is better for both the company and shareholders because no taxes are paid on repurchased shares, whereas taxes are always paid on dividends issued.

   c. Both a share repurchase and a dividend issuance will show up within the Cash Flow from Financing section of the Cash Flow Statement.

   d. Both a dividend issuance and a share repurchase will reduce the Equity line item on a company's Balance Sheet.

   e. While a share repurchase reduces the Treasury Stock line item within Equity, a dividend issuance reduces Accumulated Other Comprehensive Income (AOCI), since AOCI represents the company's saved-up, after-tax earnings.

6. **Suppose that a company has just purchased $100 of Inventory using cash, but has not yet turned the Inventory into products or sold it to customers.**

   Now it turns the Inventory into products and sells it to customers for $200, but it only collects $100 from customers in upfront cash. It is still waiting to collect the remaining $100 in cash.

   How do the three financial statements from JUST BEFORE this event to JUST AFTER this event? Assume a 40% tax rate.

   a. Net Income is unchanged; Cash is UP by $200; Inventory is DOWN by $200; Retained Earnings is unchanged.

   b. Net Income is UP by $60; Cash is UP by $260; Inventory is DOWN by $100; Retained Earnings is UP by $60.

   c. Net Income is UP by $60; Cash is UP by $60; Inventory is DOWN by $100; Retained Earnings is UP by $60.

   d. Net Income is UP by $60; Cash is UP by $160; Inventory is DOWN by $100; Retained Earnings is UP by $60.

7. **Assume that Deferred Revenue increases by $500, and then decreases by $500. Which of the following statements below are TRUE regarding the impact on the three financial statements?**

   a. When Deferred Revenue increases, taxes will not be affected because nothing is recorded on the Income Statement.

   b. Both the increase and decrease in Deferred Revenue affect the same line items (revenue, cash, and deferred revenue will change in both cases).

   c. When Deferred Revenue decreases, it corresponds to revenue being recognized on the Income Statement; as a result, both Net Income and Cash will increase.

   d. When Deferred Revenue decreases, Cash, Deferred Revenue, and Retained Earnings will be the only line items on the Balance Sheet that change.

8. **A company issues $250 worth of Long-Term Debt with an annual interest rate of 7.6% and principal repayments of $15 each year.**

   In the initial transaction, Cash on the Balance Sheet increases by $250 and Debt increases by $250 on the other side to balance it.

   Simultaneously, the company uses the debt issuance to purchase $250 worth of Long-Term Investments, which will generate Interest Income of $14 annually.

   Starting from JUST BEFORE the debt issuance and investment purchase to exactly ONE YEAR AFTER, how would the financial statements change?

   Assume that the interest expense is based on the beginning debt balance (i.e., do NOT average the beginning and ending balances). Also assume a tax rate of 40%.

   a. Net Interest Income / (Expense) on the Income Statement would be $0; Cash Flow from Financing would INCREASE by $235; Cash would DECREASE by $15.

   b. Net Interest Income / (Expense) on the Income Statement would be ($3); Cash Flow from Financing would INCREASE by $235; Cash would DECREASE by $18.

   c. Net Interest Income / (Expense) on the Income Statement would be ($3); Cash Flow from Financing would INCREASE by $250; Cash would DECREASE by $15.

   d. Net Interest Income / (Expense) on the Income Statement would be $3; Cash Flow from Financing would INCREASE by $235; Cash would DECREASE by $12.

9. **A company wants to increase its Earnings per Share (EPS) without doing anything useful, so it issues $200 of debt at a 5% interest rate and no principal amortization, and then uses the debt to repurchase $200 worth of shares.**

   The company's share price at the time of this share repurchase was $10.00.

   It had 500 shares outstanding before the share repurchase took place, along with Net Income to Common of $600 (EPS of $1.20).

   Once again, assume a tax rate of 40% and an interest expense based on the beginning debt balance, and explain how the three financial statements would change from JUST BEFORE the share purchase to JUST AFTER it.

   a. EPS would be up by ~$0.05; Cash would be unchanged; Treasury Stock would be down by $200; Retained Earnings would be unchanged.

   b. EPS would be up by ~$0.04; Cash would be down by $6; Treasury Stock would be down by $200; Retained Earnings would be down by $6.

   c. EPS would be up by ~$0.04; Cash would be down by $6; Treasury Stock would be down by $6; Retained Earnings would be down by $200.

   d. EPS would be up by ~$0.06; Cash would be up by $6; Treasury Stock would be down by $200; Retained Earnings would be up by $6.