SESSION 5A: ACCOUNTING INCONSISTENCY EXAMPLES

Accounting for Finance

1. Tax Rates

	Peloton	*Netflix*	*Coca Cola*	*Toyota*	*HSBC*	*Dr. Reddy's*
In Income Statement						
Taxable Income	$ (196)	$2,062	$ 10,786	¥2,285,465	HK$13,347	₹ 27,758
Taxes	$ -	$ 195	$ 1,801	¥659,944	HK$4,639	-₹ 1,619
Effective Tax Rate	0.00%	9.47%	16.70%	28.88%	34.76%	-5.83%
In cash flow statement						
Deferred taxes	$ -	$ (94)	$ (421)	-¥86,694	HK$0	₹ 0
Taxes paid					-HK$2,267	-₹ 4,769
In balance sheet						
Deferred Tax Assets (Liabilities)	$ 89	$ 658	$ (2,284)	-¥1,014,851	-HK$3,375	₹ 6,129

2. Non-debt Commitments

- In general, interest-bearing debt will show up on balance sheets, though some of it may be included in current liabilities (if due in less than a year) and the rest as debt.
- There are other contractual commitments that have historically not shown up on balance sheets, but should be treated like debt.
- The most common of these commitments is operating leases, but IFRS and GAAP have finally made the 'right' decision and started including them as debt in 2019.

A Retail Example: Nordstrom's

Fiscal year	Operating Leases
2020	$333
2021	353
2022	327
2023	300
2024	252
Thereafter	1,136
Total lease payments	2,701
Less: amount representing interest	(582)
Present value of net lease payments[1]	**$2,119**

Treated as 5-year annuity of $227.2 m/year (=1136/5) starting in 2025

Discounted at 4.7%

1

On the balance sheet in 2019

Current liabilities:		
Accounts payable	**$1,576**	$1,469
Accrued salaries, wages and related benefits	**510**	580
Current portion of operating lease liabilities	**244**	—
Long-term debt, net	**2,676**	2,677
Deferred property incentives, net	**4**	457
Non-current operating lease liabilities	**1,875**	—
Other liabilities	**683**	498

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Consequences for the company

- **Debt increases**: The debt on the balance sheet is augmented by the present value of lease commitments.
- **A counter asset is created**: Equivalent to the lease debt.
- **Operating income changes**, since you add back the current year's lease expense and reduce it by depreciation. Net income does not or should not change.
  - *Interest expenses go up* by the interest portion of the current year's lease payment.
  - *Depreciation is increased* by the depreciation on the lease asset (using the prior year's value)
- *Taxes and net income do not change*, since you replace one tax deductible expense (operating lease) with two (interest and depreciation) of equivalent value.

Another example: Netflix

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	As of December 31,	
	2019	2018
	(in thousands)	
Less than one year	$ 8,477,367	$ 8,611,398
Due after one year and through 3 years	8,352,731	8,841,561
Due after 3 years and through 5 years	2,041,340	1,684,582
Due after 5 years	618,644	148,334
Total streaming content obligations	$ 19,490,082	$ 19,285,875

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	2019	2018
Assets		
Current assets:		
Cash and cash equivalents	$ 5,018,437	$ 3,794,483
Current content assets, net	—	5,151,186
Other current assets	1,160,067	748,466
Total current assets	6,178,504	9,694,135
Non-current content assets, net	24,504,567	14,951,141
Property and equipment, net	565,221	418,281
Other non-current assets	2,727,420	910,843
Total assets	$ 33,975,712	$ 25,974,400
Liabilities and Stockholders' Equity		
Current liabilities:		
Current content liabilities	$ 4,413,561	$ 4,681,562
Accounts payable	674,347	562,985
Accrued expenses and other liabilities	843,043	481,874
Deferred revenue	924,745	760,899
Total current liabilities	6,855,696	6,487,320
Non-current content liabilities	3,334,323	3,759,026
Long-term debt	14,759,260	10,360,058
Other non-current liabilities	1,444,276	129,231
Total liabilities	26,393,555	20,735,635

3. Non-Physical Capital Expenses

- While accountants almost always treat investments in physical assets as capital expenses and show them on the balance sheet, they are inconsistent and unpredictable when it comes to investments in non-physical assets.
  - A pharmaceutical company that buys a patent from another one is allowed to treat that expenditure as a capital expenditure, but one that does R&D to arrive at the same result is not.
  - A company reliant on human capital for its value is almost never required to treat what it invests in human capital for the long term (recruiting and training, for example) as capital expenditures.
  - A subscriber/user based company that spends money acquiring users or subscribers generally is not allowed to treat the money spent acquiring customers as capital expenditures.

A Pharmaceutical Company Example

Step 1: Ddetermining an amortizable life for R & D expenses. (1)
How long will it take, on an expected basis, for research to pay off at Amgen? Given the length of the approval process for new drugs by the Food and Drugs Administration, we will assume that this amortizable life is 10 years.

Step 2: Capitalize historical R&D exoense

Year	*R&D Expense*		(2) *Unamortized portion*	(3) *Amortization this year*
Current	3030.00	1.00	3030.00	
-1	3266.00	0.90	2939.40	$326.60
-2	3366.00	0.80	2692.80	$336.60
-3	2314.00	0.70	1619.80	$231.40
-4	2028.00	0.60	1216.80	$202.80
-5	1655.00	0.50	827.50	$165.50
-6	1117.00	0.40	446.80	$111.70
-7	864.00	0.30	259.20	$86.40
-8	845.00	0.20	169.00	$84.50
-9	823.00	0.10	82.30	$82.30
-10	663.00	0.00	0.00	$66.30
			$13283.60	$1,694.10

(4)
Current year's R&D expense = Cap ex = $3,030 million
R&D amortization = Depreciation = $ 1,694 million
Unamortized R&D = Capital invested (R&D) = $13,284 million

Step 3: Restate earnings, book value and return numbers

(5)

	Unadjusted	*Adjusted for R&D*	*Comments*
Net Income	$4,196	4,196 + 3030 – 1694 = $ 5,532	Add current year's R&D and subtract R&D amortization
Book value of equity	$17,869	17,869 + 13,284 = $ 31,153	Add unamortized R&D from prior years
Return on Equity	$\frac{4196}{17869} = 23.48\%$	$\frac{5532}{31153} = 17.75\%$	Return on equity drops when book equity is augmented by R&D, even though net income rises.
Pre-tax Operating Income	$5,594	5,594 + 3030 – 1694 = $ 6.930	Add current year's R&D and subtract R&D amortization
Book value of invested capital	$21,985	$21,985+$13,284 = $35,269	Add unamortized R&D from prior years
Pre-tax Return on Capital	$\frac{5594}{21985} = 25.44\%$	$\frac{6930}{35269} = 19.65\%$	Return on capital drops when capital is augmented by R&D, even though operating income rises.

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4. Stock Based Compensation

- Companies following IFRS and GAAP report the current year's stock- based compensation as an operating expense, valuing both options and restricted stock at the time of issuance.
  - That said, the residue of past option grants will show up in the footnotes of these companies, with relevant information on remaining maturity and exercise price.
  - The restricted stock units granted in past years will show up as part of the discussion of share count.
- In both cases, companies will then try to reverse the accounting charge, claiming it is non-cash in reporting pro-forma or adjusted earnings.

Options Outstanding… at Netflix

Stock Option Plans

In June 2011, the Company adopted the 2011 Stock Plan. The 2011 Stock Plan provides for the grant of incentive stock options to employees and for the grant of non-statutory stock options, stock appreciation rights, restricted stock and restricted stock units to employees, directors and consultants.

A summary of the activities related to the Company's stock option plans is as follows:

		Options Outstanding			
	Shares Available for Grant	Number of Shares	Weighted- Average Exercise Price (per Share)	Weighted- Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value (in Thousands)
Balances as of December 31, 2016	13,289,953	22,437,347	$ 44.83		
Granted	(2,550,038)	2,550,038	159.56		
Exercised	—	(3,338,474)	26.79		
Expired	—	(1,561)	3.25		
Balances as of December 31, 2017	10,739,915	21,647,350	$ 61.13		
Granted	(2,039,974)	2,039,974	311.66		
Exercised	—	(3,205,911)	38.66		
Expired	—	(2,135)	$ 4.60		
Balances as of December 31, 2018	8,699,941	20,479,278	$ 89.61		
1 Granted	(2,588,380)	2,588,380	320.66		
Exercised	—	(2,208,052)	32.88		
Expired	—	(280)	6.74		
Balances as of December 31, 2019	6,111,561	20,859,326	$ 124.28	5.57	$ 4,230,013
3 Vested and exercisable at December 31, 2019		20,859,326	$ 124.28	5.57	$ 4,230,013

2	Stock-based compensation expense	405,376

And Adjusted EBITDA… at Peloton

The following table presents a reconciliation of Adjusted EBITDA to net loss, the most directly comparable financial measure prepared in accordance with GAAP, for each of the periods indicated:

	Fiscal Year Ended June 30,		
	2017	**2018**	**2019**
		(dollars in millions)	
Net loss(1)	$ (71.1)	$ (47.9)	$ (195.6)
Adjusted to exclude the following:			
Other (expense) income, net	(0.3)	(0.3)	6.7
Provision for income taxes	—	0.1	0.1
Depreciation and amortization expense	3.7	6.6	21.7
1 Stock-based compensation expense	10.3	8.5	89.5
Transaction costs	—	0.5	0.4
Litigation expenses	5.0	1.5	12.1
Ground lease expense related to build-to-suit obligations	—	—	7.2
Adjusted EBITDA	$ (51.8)	$ (30.4)	$ (71.3)
Adjusted EBITDA Margin	(23.7)%	(7.0)%	(7.8)%

Bottom Line

- Accounting statements are just raw material: In corporate finance and valuation, financial statements are raw data that should be viewed as accounting opinion and not fact.
- That you should mold to your own needs: To the extent that accounting perspectives can be outdated or reflect a different set of priorities, you should feel no qualms about redoing or reconstructing accounting statements.
- But your choices will have consequences: That can have consequences for how you measure profits, invested capital and even share count. The company that you see will be closer to the truth than the company described in accounting statements.
- Markets don’t follow (and are more sensible than) accountants: For the most part, markets learn and move on faster than accountants do. Thus, markets have been pricing in retailers, on the assumption that leases are debt for decades, while accountants made the change in 2019.