



INTERVIEW GUIDE 01

Accounting and the Three Statements

How the income statement, balance sheet and cash flow statement work, how to walk any change through all three, and the accounting topics interviewers probe.

How to use this guide

Accounting is the language of every other interview topic. Valuation, M&A and LBO questions all assume you can move a number through the three statements without hesitating.

Most questions have two layers. **What to say** is a short answer you could give in an interview. The notes underneath explain why it is right, so you can handle the follow-up.

Do not memorise answers word for word. Learn the logic, then practise saying it out loud.

01	The three statements	03
02	Walking changes through the statements	06
03	Working capital and cash conversion	13
04	Accounting topics interviewers probe	16
05	Revenue recognition	23
06	More walkthroughs	26
07	Ratios and financial analysis	31
08	Reading the filings	34
09	Quick-fire bank	37
10	Test yourself	39
11	Answers	40

A note on conventions

Worked examples use a 25% tax rate unless the question states otherwise. Where U.S. GAAP and IFRS differ in a way interviewers ask about, the guide says so. Most African markets report under IFRS; U.S. firms will expect U.S. GAAP. Say which you are assuming.

The three statements

Every technical interview starts here. If you can explain what each statement shows and how they connect, the harder questions become variations on the same logic.

1.1 Walk me through the three financial statements.

What to say

The income statement shows revenue, expenses and profit over a period. The balance sheet shows what the company owns, what it owes and the shareholders' equity at a point in time, and assets always equal liabilities plus equity. The cash flow statement starts with net income, adjusts for non-cash items and changes in working capital, then adds investing and financing flows to show how cash actually changed over the period.

1.2 Walk me through the main lines of the income statement.

What to say

Revenue, less cost of goods sold, gives gross profit. Less operating expenses such as SG&A, R&D and depreciation and amortisation gives operating income, or EBIT. Less net interest expense gives pre-tax income. Less taxes gives net income.

EBITDA is operating income with depreciation and amortisation added back. Many companies include depreciation inside cost of goods sold and operating expenses rather than showing it as its own line, which is why you often have to find it in the cash flow statement.

1.3 What are the sections of the cash flow statement?

What to say

Operating activities start from net income, add back non-cash charges such as depreciation, amortisation, stock-based compensation and impairments, remove non-cash gains, and adjust for changes in working capital and deferred taxes. Investing activities cover capital expenditure, acquisitions, asset sales and purchases of investments. Financing activities cover issuing and repaying debt, issuing and buying back shares, and dividends.

Classification of interest and dividends can differ under IFRS, which allows some choice about where interest paid and received appear. Under U.S. GAAP, interest paid sits in operating activities and dividends paid sit in financing.

1.4 If you could only have two statements, which would you choose?

What to say

The income statement and the beginning and ending balance sheets. With those I can rebuild the cash flow statement, because every cash flow line is either on the income statement or is a change in a balance sheet account.

1.5 If you could only have one, which would you choose?

What to say

The cash flow statement, because it shows what the business actually generates and spends, which is ultimately what drives value and whether the company can pay its obligations. The income statement contains many non-cash items and judgement calls.

A defensible alternative is the balance sheet, especially for a distressed company, because it shows assets available to creditors. Pick one and justify it.

1.6 How are the three statements linked?

What to say

Net income from the income statement is the first line of the cash flow statement and flows into retained earnings on the balance sheet. Non-cash items and changes in balance sheet accounts reconcile net income to cash. The ending cash on the cash flow statement becomes cash on the balance sheet. Depreciation reduces PP&E, capex increases it, and debt balances drive interest expense.

1.7 A company is profitable but runs out of cash. How?

What to say

Profit is not cash. The company could be tying up cash in receivables and inventory as it grows, spending heavily on capex, or facing large debt repayments it cannot refinance. A one-off cash charge such as a legal settlement can also do it.

The same logic explains how a company with years of positive EBITDA can still go bankrupt: interest, capex, working capital and debt maturities all sit below EBITDA.

1.8 If depreciation is non-cash, why does it affect cash?

What to say

Because it is tax deductible. Depreciation lowers taxable income, so the company pays less cash tax. At a 25% tax rate, \$10 of extra depreciation saves \$2.50 of cash.

Walking changes through the statements

These questions all follow the same routine. Start with the income statement, move to the cash flow statement, then check that the balance sheet balances.

THE ROUTINE

Income statement, cash flow, balance sheet

1. What happens to pre-tax income, and therefore to taxes and net income?
2. Start the cash flow statement with that net income change. Reverse anything non-cash, then add working capital, investing and financing effects.
3. On the balance sheet, cash moves by the net cash change, other assets and liabilities move as described, and equity moves by net income. Check that both sides change by the same amount.

2.1 Depreciation rises by \$10. Walk it through.

Statement	Effect
Income statement	Pre-tax income falls \$10. Taxes fall \$2.50. Net income falls \$7.50.
Cash flow	Net income -\$7.50, add back depreciation +\$10. Cash rises \$2.50.
Balance sheet	Cash +\$2.50, PP&E -\$10, so assets -\$7.50. Retained earnings -\$7.50. Balances.

2.2 A company buys \$100 of equipment on 31 December, funded with debt. The equipment has a five-year life and the debt costs 10%. Walk me through this year and next year.

Year 1	Effect
Income statement	No change. No depreciation or interest has built up yet.
Cash flow	Capex -\$100 in investing. Debt raised +\$100 in financing. No net change in cash.
Balance sheet	PP&E +\$100. Debt +\$100.
Year 2	
Income statement	Depreciation \$20 and interest \$10 reduce pre-tax income by \$30. Net income falls \$22.50.
Cash flow	Net income -\$22.50, add back depreciation +\$20. Cash falls \$2.50 (the \$10 of interest paid, less \$7.50 of tax saved).
Balance sheet	Cash -\$2.50, PP&E -\$20, so assets -\$22.50. Retained earnings -\$22.50. Debt unchanged.

2.3 Same equipment. On 1 January of year 3 it breaks and is worthless, and the company repays the loan. Walk it through.

Statement	Effect
Income statement	The equipment's book value is \$80. Writing it off reduces pre-tax income by \$80 and net income by \$60.
Cash flow	Net income -\$60, add back the non-cash write-down +\$80, repay debt -\$100. Cash falls \$80.
Balance sheet	Cash -\$80, PP&E -\$80, so assets -\$160. Debt -\$100, retained earnings -\$60, so liabilities and equity -\$160.

2.4 An asset is written down by \$100. Walk it through.

Statement	Effect
Income statement	Pre-tax income -\$100. Net income -\$75, assuming the write-down is tax deductible.
Cash flow	Net income -\$75, add back the write-down +\$100. Cash +\$25.
Balance sheet	Cash +\$25, asset -\$100, so assets -\$75. Retained earnings -\$75.

Real-world nuance: many write-downs, including goodwill impairments, are not deductible for tax when booked. In that case cash taxes do not change, the company records a deferred tax asset or reduces a deferred tax liability instead, and cash is unchanged. Interviewers usually want the simple version; mention the nuance if you have time.

2.5 You sell an asset for \$600 in cash. Its book value is \$500. Walk it through.

What to say

First I would ask for the book value, because the income statement only records the gain or loss.

Statement	Effect
Income statement	Gain of \$100. Net income +\$75.
Cash flow	Net income +\$75, remove the non-cash gain -\$100 in operating. Proceeds +\$600 in investing. Cash +\$575.
Balance sheet	Cash +\$575, PP&E -\$500, so assets +\$75. Retained earnings +\$75.

2.6 You sell a pair of jeans for \$20 in cash. They cost you \$10. Walk it through.

Statement	Effect
Income statement	Revenue +\$20, COGS +\$10, pre-tax income +\$10. Net income +\$7.50.
Cash flow	Net income +\$7.50, decrease in inventory +\$10. Cash +\$17.50.
Balance sheet	Cash +\$17.50, inventory -\$10, so assets +\$7.50. Retained earnings +\$7.50.

2.7 You buy \$100 of inventory for cash, then sell half of it at a 50% gross margin. Walk it through.

Half the inventory costs \$50. A 50% gross margin means cost is half of revenue, so revenue is \$100.

Statement	Effect (both events together)
Income statement	Revenue +\$100, COGS +\$50, pre-tax income +\$50. Net income +\$37.50.
Cash flow	Net income +\$37.50, net increase in inventory -\$50 (bought \$100, used \$50). Cash -\$12.50.
Balance sheet	Cash -\$12.50, inventory +\$50, so assets +\$37.50. Retained earnings +\$37.50.

A common wrong answer books revenue of \$200 on the \$100 of inventory sold. Read the question carefully: only half was sold.

2.8 You buy \$10 of inventory on credit. What happens?

What to say

Nothing on the income statement until the inventory is sold. On the cash flow statement, the increase in inventory reduces cash by \$10 and the increase in accounts payable adds \$10, so there is no net change. On the balance sheet, inventory and accounts payable both rise by \$10.

2.9 You buy a hot dog on credit for \$1 and sell it on credit for \$3. Later you collect the \$3 and pay your supplier. Walk through both events.

Event 1	Effect
Income statement	Revenue +\$3, COGS +\$1. Net income +\$1.50.
Cash flow	Net income +\$1.50, receivables -\$3, payables +\$1. Inventory went up and down by \$1, so nets to zero. Cash -\$0.50, which is the tax paid.
Balance sheet	Cash -\$0.50, receivables +\$3, so assets +\$2.50. Payables +\$1, retained earnings +\$1.50.
Event 2	
Income statement	No change.
Cash flow	Receivables fall +\$3, payables fall -\$1. Cash +\$2.
Balance sheet	Cash +\$2, receivables -\$3, so assets -\$1. Payables -\$1.

Assumes taxes are paid in cash as profit is earned.

2.10 A company issues a \$100m PIK note at 10%. What happens after one year?

Statement	Effect
At issuance	Cash +\$100m (financing), debt +\$100m. No income statement effect.
Income statement	Interest expense \$10m. Net income -\$7.5m.
Cash flow	Net income -\$7.5m, add back non-cash PIK interest +\$10m. Cash + \$2.5m from the tax saving.
Balance sheet	Cash +\$2.5m. Debt +\$10m as the interest accrues to principal. Retained earnings -\$7.5m.

2.11 A company buys back \$100 of its debt for \$80 in cash. Walk it through.

Statement	Effect
Income statement	Gain on extinguishment of \$20. Net income +\$15.
Cash flow	Net income +\$15, remove non-cash gain -\$20 in operating, repay debt -\$80 in financing. Cash -\$85.
Balance sheet	Cash -\$85. Debt -\$100, retained earnings +\$15, so liabilities and equity -\$85.

2.12 A company issues bonds with a face value of \$80 and receives \$100 in cash. What happens?

What to say

No gain is recorded. The bonds were sold at a premium, probably because their coupon is above market rates. Cash rises \$100 and debt is recorded at \$100: \$80 of face value plus a \$20 premium. The premium is amortised over the life of the bond, which reduces interest expense each year below the cash coupon.

Some prep guides book a \$20 gain at issuance. That is wrong: a company does not earn a profit by borrowing.

2.13 A truck costs \$20,000 and lasts ten years. After two years its market value is \$19,000. What is it on the balance sheet?

What to say

\$16,000 under U.S. GAAP. PP&E is carried at cost less accumulated depreciation, \$20,000 less two years of \$2,000, and is not written up when market value rises.

IFRS allows a revaluation model for PP&E, under which the truck could be carried at fair value with the increase going to other comprehensive income. Most companies still use the cost model.

2.14 A \$10 increase in depreciation in year 4. What happens to a DCF valuation?

What to say

Value rises slightly. After-tax operating profit falls by \$7.50, but depreciation is added back, so free cash flow rises by the \$2.50 tax saving. Enterprise value increases by \$2.50 discounted back four years.

This assumes the extra depreciation is also deductible for tax. If only book depreciation changes, free cash flow is unchanged.

Working capital and cash conversion

Buy-side investors care about how quickly profit turns into cash. These questions test whether you think that way.

3.1 What is working capital?

What to say

Current assets less current liabilities. In valuation and modelling, we usually use operating working capital, which excludes cash and debt: mainly receivables plus inventory less payables and accrued expenses. It measures how much cash the business has tied up in day-to-day operations.

3.2 Is an increase in receivables a source or a use of cash? Payables?

What to say

An increase in receivables is a use of cash: the company has booked revenue but not yet collected it. An increase in payables is a source of cash: the company has received goods or services but not yet paid. In general, an increase in an operating asset uses cash and an increase in an operating liability provides it.

3.3 Receivables rise by \$10m. What happens to cash?

What to say

Cash is \$10m lower than it would otherwise be. The revenue is already in net income, but the customer has not paid, so the cash flow statement subtracts the \$10m increase. Receivables are, in plain terms, IOUs from customers.

3.4 What happens to free cash flow if working capital increases?

What to say

Free cash flow falls, because more cash is tied up in the business. That is why fast-growing companies can burn cash even when profitable.

3.5 Why can negative working capital be attractive?

What to say

It means customers pay before the company pays its suppliers, so growth generates cash instead of consuming it. Subscription businesses and many retailers work this way.

The flip side: if growth stalls or reverses, the float unwinds and the company can face a sudden cash outflow.

3.6 How do you calculate days sales outstanding, days inventory and days payable?

Metric	Formula	Lower means
Days sales outstanding (DSO)	$\text{Receivables} \div \text{revenue} \times 365$	Faster collection
Days inventory outstanding (DIO)	$\text{Inventory} \div \text{COGS} \times 365$	Inventory sells faster
Days payable outstanding (DPO)	$\text{Payables} \div \text{COGS} \times 365$	Suppliers paid faster (higher DPO preserves cash)

Use purchases instead of COGS for DPO when available. Averages of opening and closing balances are more accurate than year-end figures, especially for seasonal businesses.

3.7 What is the cash conversion cycle?

What to say

DSO plus DIO minus DPO. It is roughly the number of days between paying for inputs and collecting cash from customers. A shorter cycle means less cash tied up; a negative cycle means the business is funded by its suppliers and customers.

3.8 A company has highly seasonal working capital. Is that a deal-breaker?

What to say

Not by itself. If the seasonality is predictable and there is a revolver large enough to fund the peak, it is manageable. What matters is sizing liquidity for the low point and understanding whether any inventory built for the season could go unsold.

3.9 What happens to working capital needs as a product line matures?

What to say

They typically grow more slowly, because working capital investment tracks growth. With less incremental cash tied up each year, free cash flow conversion improves.

3.10 What are the current ratio and quick ratio?

What to say

The current ratio is current assets divided by current liabilities. The quick ratio excludes inventory, and usually prepaid expenses, from current assets, because they are less easily turned into cash. Both measure short-term liquidity.

Accounting topics interviewers probe

Inventory

4.1 What are LIFO and FIFO, and what happens under each when prices are rising?

What to say

FIFO assumes the oldest inventory is sold first, so cost of goods sold reflects older, cheaper costs. LIFO assumes the newest inventory is sold first, so cost of goods sold reflects recent, higher costs. When prices rise, LIFO gives higher COGS, lower profit, lower taxes and therefore higher cash flow, and a lower inventory balance. FIFO gives the opposite.

LIFO produces a more current income statement and an out-of-date balance sheet; FIFO does the reverse. The LIFO reserve is the difference between inventory under FIFO and under LIFO, disclosed so analysts can compare companies.

LIFO is prohibited under IFRS. It is allowed under U.S. GAAP, and a U.S. company using LIFO for tax must also use it in its financial statements.

4.2 What is a LIFO liquidation?

What to say

When a LIFO company sells more inventory than it buys, it dips into older, cheaper cost layers. COGS falls and profit rises temporarily, which is a one-off and should be normalised.

4.3 Why doesn't buying inventory hit the income statement?

What to say

Inventory is an asset until it is sold. Its cost becomes an expense, cost of goods sold, in the period the related revenue is recognised. That is the matching principle.

Long-lived assets and leases

4.4 When do you capitalise a cost instead of expensing it?

What to say

When it provides a benefit beyond the current period, typically more than a year.

Capitalised costs go on the balance sheet and are depreciated if tangible or amortised if intangible over their useful life.

4.5 What are the main depreciation methods, and what is accumulated depreciation?

What to say

Straight-line spreads the cost evenly over the useful life. Accelerated methods, such as declining balance, take more expense early. Accumulated depreciation is the total depreciation recorded to date; it is netted against the asset's cost to give its book value.

4.6 How are leases accounted for?

What to say

Under current standards, most leases go on the balance sheet as a right-of-use asset and a matching lease liability. Under IFRS 16, lessees treat almost all leases like financed purchases, with depreciation and interest on the income statement. Under U.S. GAAP (ASC 842), leases are classified as finance or operating; operating leases are still on the balance sheet but show a single straight-line lease cost on the income statement.

This matters for EBITDA. Under IFRS 16, lease costs sit below EBITDA, so the same business reports higher EBITDA than under U.S. GAAP operating lease treatment. Adjust for it when comparing companies across regimes. Older guides refer to "capital leases" and the pre-2019 tests, which have been replaced.

Goodwill and intangibles

4.7 What is goodwill, and when does it change?

What to say

Goodwill is created in an acquisition. It is the purchase price less the fair value of the target's identifiable net assets, and it reflects things like the workforce, expected synergies and other value that cannot be separately recognised. It rises when a company makes acquisitions and falls when it is impaired or when a business is sold.

Identifiable intangibles such as customer relationships, brands and technology are recognised separately from goodwill, and those with finite lives are amortised.

4.8 Is goodwill amortised?

What to say

Not under IFRS or for U.S. public companies. It is tested for impairment at least annually, and written down if the business it relates to is worth less than its carrying value. The impairment is a non-cash charge on the income statement.

U.S. private companies can elect to amortise goodwill, generally over ten years or less. Separately, for U.S. tax purposes, goodwill acquired in an asset purchase is amortised over 15 years.

4.9 Why would goodwill be impaired?

What to say

Because the acquired business is performing worse than expected, market valuations have fallen, or the buyer simply overpaid. An impairment is the accounting admission that the purchase price cannot be recovered.

Taxes

4.10 What are deferred tax assets and liabilities?

What to say

They arise because book accounting and tax rules differ. A deferred tax liability means the company has paid less tax so far than its book tax expense implies, for example because of faster tax depreciation, and will pay more later. A deferred tax asset means it will pay less later, for example because of losses carried forward or expenses that are recognised in the books before they are deductible.

4.11 What is a net operating loss, and can an acquirer use the target's?

What to say

An NOL arises when tax deductions exceed taxable income. It can be carried forward to reduce future taxes. An acquirer can use the target's NOLs, but many countries restrict this after a change of control. In the U.S., Section 382 caps annual use at roughly the target's equity value multiplied by a long-term tax-exempt rate published monthly by the IRS.

U.S. federal rules: NOLs arising after 2017 can be carried forward indefinitely but offset only 80% of taxable income in a year, and carrybacks are generally not allowed. Rules differ by country; many African tax regimes cap carry-forward periods or annual use.

4.12 Is interest always tax deductible?

What to say

Not without limit. Many countries cap net interest deductions, commonly at 30% of a tax measure of EBITDA, following the OECD approach. Disallowed interest can often be carried forward.

U.S. rule (Section 163(j)): the cap is 30% of adjusted taxable income. That measure excluded depreciation and amortisation (an EBIT basis) from 2022, but 2025 legislation permanently restored the EBITDA-style basis for tax years beginning after 31 December 2024. Older guides give the EBIT version.

Revenue and earnings quality

4.13 What is the difference between cash and accrual accounting?

What to say

Cash accounting records revenue and expenses when cash moves. Accrual accounting records revenue when it is earned and expenses when they are incurred to generate it, regardless of when cash changes hands. Companies reporting under GAAP or IFRS use accrual accounting.

4.14 When can a company collect cash without recording revenue?

What to say

When it is paid before delivering the product or service: annual software subscriptions, prepaid phone contracts, magazine subscriptions, customer deposits. The cash is recorded as deferred revenue, a liability, and recognised as revenue as the company delivers.

4.15 How can a company flatter its earnings?

What to say

Aggressive revenue recognition, such as booking sales early or loosening credit terms; capitalising costs that should be expensed; lengthening useful lives to reduce depreciation; releasing reserves; classifying recurring costs as one-offs; and relying on non-cash compensation. The signs are earnings growing faster than cash flow, and receivables growing faster than revenue.

4.16 Why do companies report non-GAAP earnings, and how would you treat a \$20m restructuring charge?

What to say

To show underlying performance excluding items management considers non-recurring or non-cash, such as restructuring, amortisation of acquired intangibles and stock-based compensation. I would add a genuinely one-off restructuring charge back to EBITDA, net of tax for earnings, but check the history: if the company "restructures" every year, it is a recurring cost.

Stock-based compensation is a real cost to shareholders even though it is non-cash. Many investors do not add it back.

4.17 What are extraordinary items?

What to say

The category no longer exists. U.S. GAAP removed it in 2015 and IFRS prohibits it. Unusual or infrequent items are now reported within continuing operations and disclosed separately, and analysts adjust for them.

Investments and other items

4.18 How are investment securities accounted for?

What to say

Under U.S. GAAP, debt securities are classified as trading (fair value through net income), available-for-sale (fair value through other comprehensive income) or held-to-maturity (amortised cost). Most equity investments without significant influence are carried at fair value through net income. IFRS 9 uses a similar approach based on the business model and cash flow characteristics.

4.19 What is net debt?

What to say

Total debt less cash and cash equivalents. It shows what the company would owe if it used its cash to repay debt. Many analysts also include lease liabilities and other debt-like items, so state your definition.

4.20 Can shareholders' equity be negative? What would it mean?

What to say

Yes. Common causes are years of accumulated losses, large debt-funded dividends or buybacks, and write-downs. It is not automatically a warning sign; many healthy companies with large buybacks have negative book equity. It does mean book value is useless for valuation.

4.21 What is securitisation?

What to say

Pooling cash-generating assets such as mortgages, loans or receivables and selling securities backed by their cash flows, usually in tranches with different risk. Mortgage-backed securities and collateralised loan obligations are examples.

4.22 What is fair value, and what is mark-to-market?

What to say

Fair value is the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants. Marking to market means recording an asset at its current fair value rather than its cost, which is how trading securities are carried.

Revenue recognition

The single most common source of earnings manipulation, and the topic most candidates skip. Both U.S. GAAP and IFRS now use the same five-step model.

5.1 When can a company recognise revenue?

What to say

When it transfers control of a good or service to the customer. The five steps are: identify the contract, identify the performance obligations in it, determine the transaction price, allocate that price to each obligation, and recognise revenue as each obligation is satisfied.

Practically, that means a one-off product sale is recognised on delivery, a subscription is recognised over the service period, and a long-term contract is recognised as the work is performed.

5.2 What is the difference between gross and net revenue recognition?

What to say

If the company controls the good or service before it reaches the customer, it is the principal and reports the full amount as revenue, with the cost in COGS. If it merely arranges the transaction, it is an agent and reports only its commission. The test is control, not who holds inventory or takes the payment.

Why it matters. A marketplace reporting \$200m of gross merchandise value as revenue at a 3% margin looks very different from one reporting \$24m of net revenue at a 60% margin, even though the economics are identical. This is a standard trap in growth and internet company analysis.

5.3 What is deferred revenue, and what is a contract asset?

What to say

Deferred revenue, or a contract liability, arises when the customer pays before the company delivers: cash in, a liability recorded, revenue recognised later. A contract asset is the reverse: the company has delivered and earned revenue but does not yet have an unconditional right to bill, so it sits as an asset distinct from receivables.

5.4 How is a long-term construction or services contract recognised?

What to say

Over time, using a measure of progress, most often costs incurred as a percentage of total expected costs. If a contract is 40% complete on cost and the total price is \$100m, \$40m of revenue is recognised. Expected losses on a contract are recognised immediately and in full, not spread.

This is where engineering and construction companies get into trouble: progress depends on management's estimate of total cost, so an optimistic estimate pulls profit forward. Watch for rising contract assets, or unbilled receivables, relative to revenue.

5.5 A software company sells a three-year licence with implementation and support for \$360,000 upfront. How is it recognised?

What to say

Split the price across the separate performance obligations by their standalone selling prices. The licence, if it gives a right to use the software as it exists, is recognised at delivery; implementation is recognised as the work is done; support is recognised over the three years. So the first year's revenue is much lower than the \$360,000 of cash received, and the difference sits in deferred revenue.

5.6 What are the classic revenue recognition red flags?

- Revenue growing faster than cash collections, with receivables and unbilled balances rising.
- Heavy shipments into distributors at quarter end, called channel stuffing, and rising returns afterwards.
- Bill-and-hold arrangements, where revenue is booked before the customer takes the goods.

- Side letters giving customers rights of return or cancellation that are not reflected in the accounts.
 - A change in the estimate of total contract cost that conveniently raises current-period profit.
 - Recognising gross when the company is really an agent.
-

5.7 How do you treat customer incentives, rebates and discounts?

What to say

Generally as a reduction of revenue, not as a marketing expense, because they reduce the transaction price. Variable consideration such as volume rebates must be estimated and constrained to the amount the company is confident it will keep. Companies that book incentives as costs rather than contra-revenue overstate both revenue and gross margin.

More walkthroughs

Fifteen more changes to move through the statements. Use a 25% tax rate throughout, and use the same routine: income statement, cash flow, balance sheet, then check.

6.1 A company issues \$200 of new shares.

What to say

No income statement effect. Financing cash flow +\$200. Cash +\$200 and share capital plus paid-in capital +\$200.

6.2 The company then buys back \$50 of shares.

What to say

No income statement effect. Financing cash flow -\$50. Cash -\$50 and equity -\$50, shown either as treasury stock or as a reduction in share capital and retained earnings depending on the jurisdiction.

6.3 A dividend of \$40 is declared but not yet paid.

What to say

No income statement effect and no cash movement yet. Retained earnings fall \$40 and a dividend payable liability of \$40 is recorded. When it is paid, cash and the liability both fall \$40, in financing.

6.4 A customer prepays \$120 for a year of service. What happens at the prepayment, and after one month?

What to say

At prepayment: cash +\$120, deferred revenue +\$120, no income statement effect. After one month: revenue \$10, net income +\$7.50, deferred revenue falls to \$110, and the cash flow statement shows net income of \$7.50 with a \$10 reduction in deferred revenue, so cash falls \$2.50, which is the tax paid.

6.5 The company records a \$30 bad debt provision.

What to say

Income statement: expense \$30, net income -\$22.50. Cash flow: net income -\$22.50, add back the non-cash provision +\$30, so cash +\$7.50 from the tax effect, if deductible. Balance sheet: receivables fall \$30 net through the allowance, cash +\$7.50, retained earnings -\$22.50.

In many tax regimes a general provision is not deductible until the debt is actually written off. If so, there is no tax benefit: net income falls \$30 and cash is unchanged.

6.6 Inventory worth \$40 is written down to \$25.

What to say

Income statement: \$15 charge in COGS, net income -\$11.25. Cash flow: net income -\$11.25, add back the non-cash write-down +\$15, so cash +\$3.75. Balance sheet: inventory -\$15, cash +\$3.75, retained earnings -\$11.25.

6.7 The company records \$60 of stock-based compensation.

What to say

Income statement: expense \$60, net income -\$45. Cash flow: added back in full as non-cash, so cash rises \$15 from the tax deduction if available. Balance sheet: cash +\$15, paid-in capital +\$60, retained earnings -\$45.

Stock compensation is a real cost: it transfers value from existing shareholders to employees through dilution. Adding it back to EBITDA, as many companies do, flatters the numbers.

6.8 The company capitalises \$50 of software development that it previously expensed.

What to say

Income statement: expense falls \$50, so net income rises \$37.50. Cash flow: net income + \$37.50, but \$50 moves out of operating into investing as capex, so operating cash flow rises \$50 while total cash falls \$12.50 from the extra tax paid. Balance sheet: intangible assets +\$50, cash -\$12.50, retained earnings +\$37.50.

This is why analysts look at free cash flow rather than operating cash flow: capitalising costs improves reported profit and operating cash flow simultaneously while changing nothing about the business.

6.9 The company factors \$100 of receivables for \$95 in cash.

What to say

Income statement: a \$5 financing or discount cost, net income -\$3.75. Cash flow: net income -\$3.75 and receivables fall \$100, so cash rises about \$96.25 depending on classification. Balance sheet: receivables -\$100, cash +\$96.25, retained earnings -\$3.75. If the factoring is with recourse, it is effectively borrowing and should be shown as debt.

Watch for this in working-capital-heavy businesses: factoring can make days sales outstanding look excellent while the company is really paying for short-term debt.

6.10 A lease with a present value of \$100 commences.

What to say

At commencement: a right-of-use asset of \$100 and a lease liability of \$100, with no cash movement and no income statement effect. Then each period, the asset is amortised and, for a finance lease or under IFRS 16, interest accrues on the liability, with the cash payment split between interest and principal repayment.

6.11 A company impairs goodwill by \$80, with no tax deduction.

What to say

Income statement: \$80 charge, net income $-\$80$ with no tax benefit. Cash flow: net income $-\$80$, add back the non-cash impairment $+\$80$, so cash is unchanged. Balance sheet: goodwill $-\$80$, retained earnings $-\$80$.

6.12 The company issues a \$100 convertible bond at par with a 5% coupon.

What to say

At issuance: cash $+\$100$ and debt $+\$100$, though under some standards part of the proceeds is allocated to an equity conversion feature. Each year, interest of \$5 reduces net income by \$3.75. On conversion, the debt is removed and equity increases, and the share count rises, which is why diluted EPS treats in-the-money convertibles as converted.

6.13 A foreign subsidiary's currency falls 20%. What happens?

What to say

Translation of the subsidiary's assets and liabilities at the new rate creates a translation adjustment that goes to other comprehensive income within equity, not through net income. Reported revenue and profit from that subsidiary fall when translated. A transaction loss, such as a dollar-denominated payable in a local-currency business, does hit the income statement.

6.14 A company acquires a business for \$500, paying \$300 in cash and \$200 in stock.

What to say

Cash flow: \$300 outflow in investing, net of cash acquired; the stock portion is non-cash. Balance sheet: the target's assets and liabilities are added at fair value, goodwill is recorded for the excess, cash $-\$300$, and equity $+\$200$. Income statement: the target's results are consolidated from the acquisition date, with higher amortisation on new intangibles and the transaction fees expensed.

6.15 A company owns 70% of a subsidiary. How does that appear?

What to say

The subsidiary is fully consolidated: 100% of revenue, costs, assets and liabilities appear. The 30% the parent does not own is shown as a non-controlling interest: a share of net income deducted to reach income attributable to the parent, and a line within equity on the balance sheet. That is why enterprise value adds non-controlling interests, as Guide 02 explains.

Ratios and financial analysis

7.1 Walk me through the DuPont decomposition of return on equity.

What to say

Return on equity equals net margin times asset turnover times financial leverage: net income over revenue, revenue over assets, assets over equity. It shows whether a high return on equity comes from profitability, efficiency or borrowing. Two companies with 20% return on equity are very different if one gets there on margin and the other on 5x leverage.

	Company A	Company B
Net margin	10%	3%
Asset turnover	1.0x	1.3x
Assets ÷ equity	2.0x	5.1x
Return on equity	20%	20%

Same return, different risk. B's return disappears in a downturn.

7.2 What is the difference between ROA, ROE, ROIC and ROCE?

Metric	Formula	What it answers
ROA	Net income ÷ total assets	How productively the whole asset base is used
ROE	Net income ÷ shareholders' equity	The return to shareholders, including the effect of leverage
ROIC	EBIT × (1 – tax) ÷ (debt + equity – cash)	The return on the capital actually invested in operations, independent of capital structure

ROCE	$\text{EBIT} \div (\text{total assets} - \text{current liabilities})$	A pre-tax version common outside the U.S.
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ROIC is the one investors care most about, because comparing it with the cost of capital tells you whether growth creates or destroys value.

7.3 What does it mean if ROIC is below the cost of capital?

What to say

Every additional dollar invested destroys value, so growth makes the company worse, not better. The right response is to stop investing and return capital, or to fix the returns. A company in that position trading on a growth multiple is a good short candidate.

7.4 What is the difference between gross, EBITDA, EBIT and net margin, and which do you use?

What to say

Gross margin shows pricing power and unit economics. EBITDA margin shows operating performance before capital structure and accounting for capital, which is why it is used for comparisons. EBIT margin includes the cost of using capital assets through depreciation, so it is better for capital-intensive businesses. Net margin includes financing and tax and therefore reflects the specific company's structure rather than the business.

7.5 How do you compare two companies with different accounting policies?

What to say

Normalise before comparing: put both on the same inventory method where disclosure allows, adjust for lease treatment if one reports under IFRS and the other under U.S. GAAP, treat capitalised development consistently, strip out one-off items, and use the same definition of net debt. Then compare margins and returns.

7.6 How would you tell whether earnings are high or low quality?

What to say

Compare cumulative operating cash flow with cumulative net income over several years: they should track. Then check whether growth in receivables, inventory and capitalised costs outpaces revenue, how large and recurring the adjustments to reported earnings are, and whether the effective tax rate and provisions move conveniently. High-quality earnings convert to cash and do not depend on estimates.

7.7 What is a common-size analysis, and why use it?

What to say

Expressing every income statement line as a percentage of revenue and every balance sheet line as a percentage of assets, then tracking it over five years and against peers. It is the fastest way to see where a business changed: gross margin drifting down, overheads creeping up, working capital expanding.

Reading the filings

8.1 What is in an annual report, and where do you actually look?

Section	What you get from it
Business description	Segments, products, customers, competition, and how the company describes its own strategy
Risk factors	Mostly boilerplate, but new or reordered risks are a signal
Management discussion	Management's explanation of the numbers, including the drivers of revenue and margin changes
Financial statements	The three statements plus the statement of changes in equity
Accounting policies note	Revenue recognition, capitalisation, depreciation lives, provisions. Read this before trusting a margin
Segment note	Where profitability actually sits; often more useful than the whole income statement
Debt note	Maturities, rates, covenants, security and undrawn facilities
Commitments and contingencies	Leases, guarantees, litigation, purchase obligations
Related-party note	Transactions with owners and affiliates. Short, and often the most revealing page in the report
Subsequent events	What happened after the balance sheet date but before publication
Auditor's report	The opinion and any qualification, emphasis of matter or going-concern language

Priority order for a first pass: segment note, cash flow statement, debt note, accounting policies, related parties. The press release is last.

8.2 What is a going-concern qualification?

What to say

A statement that there is material uncertainty about whether the company can continue operating for at least the next twelve months, usually because of liquidity or covenant pressure. It is not a bankruptcy prediction, but it does affect lenders, customers and suppliers, and it often precedes a refinancing or a restructuring.

8.3 Which U.S. GAAP and IFRS differences should you be able to name?

Topic	U.S. GAAP	IFRS
Inventory	FIFO or LIFO permitted	LIFO prohibited
PP&E measurement	Cost less depreciation only	Cost or revaluation model
Leases	Finance and operating classification, with operating leases showing a single straight-line expense	Essentially all leases treated like financed purchases, with depreciation and interest
Development costs	Generally expensed, with limited software exceptions	Capitalised when specific criteria are met
Impairment	Two-step for long-lived assets; reversals generally prohibited	One-step; reversals permitted for assets other than goodwill
Goodwill amortisation	Not amortised for public entities; private entities may elect to amortise	Not amortised; impairment tested

8.4 What is a quality of earnings report, and how does it differ from an audit?

What to say

A quality of earnings report is commissioned by a buyer to test whether reported EBITDA reflects sustainable performance: it normalises one-offs, checks revenue recognition, tests working capital, and challenges the seller's adjustments. An audit gives an opinion on whether the statements comply with the accounting framework. An audit says the numbers are right; a quality of earnings report says what the numbers mean.

8.5 What is adjusted EBITDA, and which adjustments would you accept?

What to say

Reported EBITDA plus items management considers non-recurring or not reflective of the ongoing business. I would generally accept genuinely one-off legal settlements, transaction costs, owner compensation above market in a private company, and costs of a facility that has closed. I would challenge run-rate synergies not yet achieved, "growth investments" that recur every year, capitalised costs presented as savings, and any adjustment that appears in three consecutive years.

Quick-fire bank

One or two sentences each. These are warm-up questions; answer without hesitating.

Question	Answer
Is depreciation an operating or non-operating expense?	Operating. It is the cost of using assets in the business.
Where does interest expense appear on the cash flow statement?	Within operating activities under U.S. GAAP, because it is already in net income; IFRS permits operating or financing.
Why is EBITDA not free cash flow?	It ignores capex, working capital, interest and tax, all of which consume real cash.
What is the difference between accounts payable and accrued expenses?	Payables are invoiced amounts owed to suppliers; accruals are costs incurred but not yet invoiced, such as wages or interest.
Is a deferred tax liability real debt?	Not contractually, but it represents future cash tax. Analysts often exclude it from net debt while noting it.
Why can operating cash flow exceed EBITDA?	A large working capital release, or non-cash charges above the EBITDA line such as provisions and stock compensation.
What is the effect of a stock split?	None on value: share count rises and price falls proportionally. EPS and per-share history are restated.
What is other comprehensive income?	Gains and losses that bypass net income, such as currency translation, some pension effects and certain hedges, accumulated within equity.
Why do companies report a different tax rate than the statutory one?	Foreign earnings taxed at different rates, permanent differences, credits, valuation allowances and one-off settlements.

What is working capital's relationship with growth?	Most businesses need more working capital as they grow, so growth consumes cash before it produces it.
What is a provision?	A liability for an obligation whose amount or timing is uncertain, recognised when probable and estimable. Non-cash when booked, cash when settled.
What happens on the statements when a company pays down debt with cash?	No income statement effect at the time; financing cash outflow; cash and debt both fall. Future interest expense falls.
Why look at cash conversion of EBITDA?	It tells you what percentage of reported profit is available to service debt, invest or distribute; below about 50% deserves an explanation.
What does negative goodwill mean?	The purchase price was below the fair value of net assets acquired, a bargain purchase, recognised as a gain in income after checking the fair values.
Can net income be positive while retained earnings fall?	Yes, if dividends or buybacks charged to retained earnings exceed net income.
What is the difference between a write-down and a write-off?	A write-down reduces an asset's carrying value; a write-off removes it entirely.

Test yourself

Answer each one out loud before checking. Use a 25% tax rate.

#	Question
1	A company records \$50 of stock-based compensation. What happens to net income and cash?
2	Receivables rise \$30 and payables rise \$10. What is the net effect on operating cash flow?
3	A company pays a \$40 dividend. Walk it through.
4	Prices are falling. Which gives higher net income, LIFO or FIFO?
5	Revenue is \$365m and receivables are \$45m. What is DSO?
6	DSO is 40, DIO is 50 and DPO is 60. What is the cash conversion cycle?
7	A customer prepays \$12 for a year of service. What is on the balance sheet after three months?
8	Why might a company show rising net income and falling operating cash flow?
9	A company reports under IFRS 16. Is its EBITDA higher or lower than an identical U.S. GAAP company with operating leases?
10	Goodwill of \$200 is impaired by \$50 and the impairment is not tax deductible. What happens to net income and cash?

Answers

#	Answer
1	Net income falls \$37.50, assuming the expense is deductible. On the cash flow statement it is added back (\$50), so cash rises \$12.50 from the tax saving. Equity: retained earnings -\$37.50, paid-in capital +\$50, total +\$12.50, matching the cash.
2	Operating cash flow is \$20 lower: -\$30 for receivables, +\$10 for payables.
3	No income statement effect. Financing cash flow -\$40. Cash -\$40 and retained earnings -\$40.
4	LIFO. The newest, cheapest costs flow into COGS first.
5	$\$45\text{m} \div \$365\text{m} \times 365 = 45 \text{ days}$.
6	$40 + 50 - 60 = 30 \text{ days}$.
7	Cash +\$12, before tax. Deferred revenue of \$9 for the nine months still owed. Revenue of \$3 has been recognised, so retained earnings rise by \$3 less tax.
8	Working capital is absorbing cash (receivables or inventory growing), non-cash gains are boosting income, or costs are being capitalised.
9	Higher. Under IFRS 16, lease costs appear as depreciation and interest, both below EBITDA.
10	Net income falls \$50 (no tax benefit). Cash is unchanged: the \$50 is added back on the cash flow statement.

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