UNIVERSITY INVESTMENT CLUB

1.0 Accounting Guide

Financial Statements, Linkages & Statement-Impact Questions

Guide 1 of 6 | IB & PE Interview Prep Series

Compiled for internal club use. Questions are illustrative and drawn from commonly tested technical themes in IB and PE recruiting — not affiliated with, or sourced verbatim from, any bank or recruiting firm.

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Accounting questions test whether you understand how the three financial statements fit together — the single most common technical screen in IB and PE interviews. Work through each scenario yourself before checking the answer.

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1. Core Concepts

Q1.1 Walk me through the three financial statements.

The **Income Statement** shows revenue, expenses, and taxes over a period of time, ending in Net Income.

The **Balance Sheet** shows a company's Assets and how those assets were funded — through Liabilities and Shareholders' Equity — at a single point in time. Assets must always equal Liabilities plus Equity.

The **Cash Flow Statement** starts with Net Income, adjusts for non-cash items and changes in operating assets/liabilities, and then layers in investing and financing activity to arrive at the net change in cash for the period.

Q1.2 How do the three statements link together?

Net Income flows from the bottom of the Income Statement to the top of the Cash Flow Statement. Non-cash charges (D&A, stock-based comp) are added back, and changes in operating Balance Sheet items are reflected. Investing and financing activity is added to reach the net change in cash, which flows into the new period's Balance Sheet cash balance. Net Income also flows into Retained Earnings on the Balance Sheet, keeping Assets = Liabilities + Equity.

Q1.3 If you could only look at one statement to assess a company's health, which would you pick?

The **Cash Flow Statement** — it strips out non-cash accounting noise and shows how much cash the business is actually generating, which is what ultimately matters.

Q1.4 What's the difference between Accounts Receivable and Deferred Revenue?

Accounts Receivable is revenue that has been **recognized** but not yet collected in cash — an Asset, because it implies future cash coming in. Deferred Revenue is cash that has been **collected** but not yet recognized as revenue — a Liability, because the company still owes the product or service (and will owe additional future taxes once it's recognized).

Q1.5 What's Working Capital, and what does negative Working Capital imply?

Working Capital = Current Assets – Current Liabilities. Operating Working Capital excludes cash, investments, and debt to isolate the purely operational items.

Negative Working Capital isn't automatically bad — subscription businesses and retailers (e.g., collecting cash upfront while paying suppliers later) often run negative Working Capital as a sign of efficiency. In other cases it can signal financial strain.

2. Single-Item Statement Impacts

Q2.1 Depreciation increases by $10. Walk me through the statements (40% tax rate).

IS: Operating Income and Pre-Tax Income fall by $10; Net Income falls by $6.

CFS: Net Income is down $6, but the $10 of Depreciation is added back (non-cash), so cash is up $4.

BS: PP&E falls $10, Cash rises $4 (Assets down $6 net); Retained Earnings falls $6 to balance.

Q2.2 Accounts Receivable increases by $10. What happens?

This means revenue was recognized but not yet collected. **IS:** Revenue and Net Income rise. **CFS:** Net Income is up, but AR increasing is a cash outflow adjustment, so cash rises by less than Net Income (roughly the after-tax amount minus the AR increase). **BS:** AR up, Cash up by less, Retained Earnings up — balances.

Q2.3 Inventory increases by $10, paid in cash. What happens?

IS: No change — nothing has been manufactured or sold yet.

CFS: Inventory (an Asset) increasing reduces Cash Flow from Operations by $10.

BS: Inventory up $10, Cash down $10 — Assets unchanged, Balance Sheet still balances.

Q2.4 A company sells equipment for $120 that's on the books at $100. Walk it through.

IS: A $20 Gain is recorded, boosting Pre-Tax Income; Net Income rises by $12 at 40%.

CFS: Net Income is up $12, but the $20 Gain is subtracted out of CFO (it's reclassified) and the full $120 in proceeds shows up under Cash Flow from Investing. Net cash impact: +$112.

BS: Cash up $112, PP&E down $100 (Assets up $12 net); Retained Earnings up $12 — balances.

Q2.5 A company issues $100 of Stock-Based Compensation. What happens?

IS: SBC is a tax-deductible, non-cash expense — Pre-Tax Income falls $100, Net Income falls $60.

CFS: Net Income down $60, but SBC is added back as non-cash — cash rises $40 (the tax savings).

BS: Cash up $40; Common Stock & APIC up $100 (reflecting the equity issued); Retained Earnings down $60 — balances.

Q2.6 Why does adding back a non-cash expense on the CFS increase cash by less than the full expense?

Because the expense already reduced Net Income by its after-tax impact. Adding back the full pre-tax expense on top of that after-tax hit correctly isolates the true cash benefit: the tax savings the non-cash charge generated.

3. Multi-Step & Advanced Scenarios

Q3.1 A company buys a $100 factory with debt, then a year later depreciates it 10% and pays 10% interest. Walk through year two.

IS: Depreciation of $10 and Interest Expense of $10 both hit Pre-Tax Income, down $20 total; Net Income falls $12.

CFS: Net Income down $12, Depreciation of $10 added back — CFO down $2, so cash falls $2 (Debt principal is untouched since it's high-yield debt with no amortization).

BS: Cash down $2, PP&E down $10 (Assets down $12); Retained Earnings down $12 — balances. Debt is unchanged.

Q3.2 What's the difference between a Deferred Tax Asset and a Deferred Tax Liability?

A **DTL** means the company has underpaid cash taxes relative to book taxes and will owe more in the future (common when tax depreciation runs faster than book depreciation). A **DTA** means the opposite — the company has effectively overpaid and will save on cash taxes later (common with Net Operating Losses).

Q3.3 You own 70% of a company that earns $10 of Net Income. How is this reflected?

The subsidiary's full financials are **consolidated** — 100% of its statements are added to yours. A **Noncontrolling Interest** (Liabilities & Equity) line is created for the 30% you don't own.

On the IS, you subtract $3 (30% × $10) as "Net Income Attributable to Noncontrolling Interests." On the CFS, you add that $3 back since you do receive 100% of the cash. On the BS, Noncontrolling Interest rises $3 while Retained Earnings falls $3 to balance.

Q3.4 You own 30% of a company that earns $20 of Net Income. How is this different?

This is an **Equity Method** investment (20%–50% ownership) — you do *not* consolidate. Instead, you record your $6 share (30% × $20) as "Income from Equity Interests" on the IS, subtract it out on the CFS as non-cash, and grow an "Investments in Equity Interests" Asset by $6 on the BS. Dividends received later reduce that Asset and are added back as a real cash inflow on the CFS.

Q3.5 A $100 write-down hits an asset that is not tax-deductible for cash tax purposes. What happens?

IS (book): Pre-Tax Income falls $100, Net Income falls $60 (at 40%).

CFS: Net Income down $60; add back the full $100 non-cash write-down; then subtract $40 because cash taxes are actually $40 higher than book taxes this period (no tax deduction received yet) — net cash impact is roughly $0 initially, with a Deferred Tax Asset building up to be used in future periods.

BS: The written-down asset falls $100; a Deferred Tax Asset of $40 is created; Retained Earnings falls $60 — balances.