TECHNICAL PRIMER

Financial Statements, EBITDA & SDE

How to read the three financial statements, how they connect, and how buyers restate a small company's profit into the earnings they actually pay for.

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HOW TO USE THIS PRIMER

This is the accounting foundation for every other technical primer. One illustrative company is used throughout so you can see the same numbers move from the income statement to the cash flow statement to the balance sheet. Rebuild each table yourself in Excel; if your totals match, you understand the links. The interview questions cover the accounting questions most often asked in banking and private equity interviews. You are not expected to master every detail: the goal is a basic understanding of each concept, and the extra depth is here for when you want it.

Every valuation starts with earnings, and every earnings number starts with the financial statements. A buyer has to be able to read them, see how they connect, and then restate a small company's reported profit into what a new owner would actually earn.

One illustrative company runs through this primer: a service business with **$4.0 million of revenue**, owned and run by its founder. Its figures tie to the deal used in Primers 2 and 3.

1. The Income Statement

1.1 What it shows

> **The income statement** (also called the profit and loss statement, or P&L) shows revenue earned and expenses incurred over a period, usually a year or a quarter, and the profit left at the end.

It is prepared on an **accrual basis**: revenue is recorded when it is earned, not when cash arrives, and expenses are recorded when they are incurred, not when they are paid. That is why a profitable company can still run out of cash.

1.2 Reading it top to bottom

WORKED EXAMPLE: INCOME STATEMENT

Line	Amount	What it means
Revenue	$4,000,000	Sales of services to customers
(−) Cost of goods sold (COGS)	($2,400,000)	Direct costs: technicians' wages, materials
Gross profit	**$1,600,000**	**40% gross margin**
(−) Selling, general & administrative (SG&A)	($1,130,000)	Office staff, rent, insurance, owner's salary of $150,000, a one-time $20,000 lawsuit settlement
(−) Depreciation & amortization (D&A)	($40,000)	The yearly cost of trucks and equipment bought in past years
Operating income (EBIT)	**$430,000**	**Earnings before interest and taxes**
(−) Interest expense	($30,000)	On the company's equipment loan
Pre-tax income	**$400,000**	
(−) Income taxes (25%)	($100,000)	
Net income	**$300,000**	**7.5% net margin**

Illustrative. The 25% tax rate is a simplification.

FORMULA: MARGINS

Margin = Profit measure ÷ Revenue

Gross margin = $1.6M ÷ $4.0M = 40%. Operating (EBIT) margin = $430K ÷ $4.0M = 10.8%. Net margin = $300K ÷ $4.0M = 7.5%. Margins let you compare companies of different sizes.

INTERVIEW QUESTIONS

What is the difference between COGS and operating expenses?

COGS are costs directly tied to delivering the product or service and rise with each sale. Operating expenses (SG&A) are the costs of running the business overall, such as office staff and rent, and are more fixed.

Can a company have positive net income and still go bankrupt?

Yes. Net income is an accrual measure. If customers pay slowly, inventory builds up or large debt payments come due, the company can run out of cash while still reporting a profit.

2. The Balance Sheet

2.1 What it shows

The balance sheet shows what a company owns (assets), what it owes (liabilities) and what belongs to the owners (equity) at a single point in time.

FORMULA: THE ACCOUNTING EQUATION

Assets = Liabilities + Equity

It always balances, because every asset was paid for either by borrowing (a liability) or by the owners (equity).

WORKED EXAMPLE: BALANCE SHEET AT YEAR END

Line	Last year	This year
Cash	$180,000	$200,000
Accounts receivable (owed by customers)	$450,000	$500,000
Inventory	$260,000	$280,000
Property, plant & equipment, net	$400,000	$420,000
Total assets	**$1,290,000**	**$1,400,000**
Accounts payable (owed to suppliers)	$190,000	$200,000
Equipment loan	$500,000	$400,000
Owner's equity	$600,000	$800,000
Total liabilities and equity	**$1,290,000**	**$1,400,000**

Equity rose by $200,000: net income of $300,000 minus $100,000 the owner took out as distributions. PP&E rose by $20,000: $60,000 of new equipment minus $40,000 of depreciation.

Illustrative.

2.2 Working capital

Net working capital (NWC) is the money tied up in running the business day to day: accounts receivable plus inventory, minus accounts payable. Cash and debt are usually excluded.

WORKED EXAMPLE

Last year: $450,000 + $260,000 − $190,000 = $520,000. This year: $500,000 + $280,000 − $200,000 = $580,000.

NWC rose by **$60,000**. That $60,000 is profit the company earned but could not spend, because it is sitting in unpaid invoices and inventory. A growing company usually needs more working capital every year.

Days sales outstanding (how long customers take to pay) = $500,000 ÷ $4,000,000 × 365 = **about 46 days**.

Illustrative.

INTERVIEW QUESTIONS

Why must the balance sheet always balance?

Every asset has to be funded by someone: creditors (liabilities) or owners (equity). Every transaction changes both sides by the same amount, or moves value within one side.

If accounts receivable rises, what happens to cash?

Cash is lower than profit by that amount: the revenue was recorded, but the customer has not paid yet.

3. The Cash Flow Statement

3.1 What it shows

The cash flow statement explains how the cash balance changed over the period, in three parts: operating activities (running the business), investing activities (buying or selling long-term assets) and financing activities (borrowing, repaying and payments to or from owners).

WORKED EXAMPLE: CASH FLOW STATEMENT

Line	Amount	Why
Net income	$300,000	From the income statement
(+) Depreciation & amortization	$40,000	An expense, but no cash left this year
(−) Increase in accounts receivable	($50,000)	Revenue recorded, not yet collected
(−) Increase in inventory	($20,000)	Cash spent on stock not yet used
(+) Increase in accounts payable	$10,000	Expenses recorded, not yet paid
Cash from operations	**$280,000**	
(−) Capital expenditures	($60,000)	New equipment
Cash from investing	**($60,000)**	
(−) Loan repayment	($100,000)	Debt fell from $500K to $400K
(−) Owner distributions	($100,000)	Cash the owner took out
Cash from financing	**($200,000)**	
Net change in cash	**$20,000**	**Cash went from $180K to $200K ✓**

Illustrative.

3.2 Free cash flow

FORMULA

Free cash flow = Cash from operations − Capital expenditures

The cash the business generates after keeping its equipment running, available to repay debt or pay owners. Here: $280,000 − $60,000 = **$220,000**. This, not net income, is what pays an acquisition loan.

3.3 How the three statements connect

Link	From	To
Net income	Bottom of the income statement	Top of the cash flow statement, and added to retained earnings in equity
Depreciation	Expense on the income statement	Added back on the cash flow statement; reduces PP&E on the balance sheet
Working capital changes	Balance sheet (AR, inventory, AP)	Operating section of the cash flow statement
Capital expenditures	Investing section of the cash flow statement	Increase PP&E on the balance sheet
Ending cash	Bottom of the cash flow statement	Cash on the balance sheet

WORKED EXAMPLE: THE CLASSIC INTERVIEW QUESTION

Depreciation rises by $10. Walk me through the three statements (25% tax rate).

Income statement: operating income falls by $10; taxes fall by $2.50; net income falls by $7.50.

Cash flow statement: net income is down $7.50, but depreciation of $10 is added back, so cash from operations rises by **$2.50**. That $2.50 is the tax saving.

Balance sheet: cash is up $2.50 and PP&E is down $10, so assets fall by $7.50. Retained earnings fall by $7.50 (the lower net income), so equity falls by $7.50. Both sides fall by $7.50; it balances.

INTERVIEW QUESTIONS

If you could use only one statement to judge a company, which would you choose?

The cash flow statement, because it shows whether the business actually produces cash, which accrual profit can hide. (Some interviewers accept the balance sheet with a good reason; the point is to explain your choice.)

A company buys $100 of equipment with cash. What changes on each statement at the moment of purchase?

Income statement: nothing yet. Cash flow statement: capital expenditures of −$100 in investing. Balance sheet: cash down $100, PP&E up $100; total assets unchanged.

4. EBITDA

4.1 Why buyers do not use net income

Net income depends on choices the current owner made: how much debt they took on (interest), their tax situation, and how they accounted for past equipment purchases. A buyer will have different debt, taxes and accounting. So buyers use a measure of the earning power of the operations themselves.

EBITDA is earnings before interest, taxes, depreciation and amortization. It is the basis for most valuation multiples in investment banking and private equity.

FORMULA

EBITDA = Net income + Interest + Taxes + Depreciation & amortization

Equivalently, EBITDA = Operating income (EBIT) + D&A.

WORKED EXAMPLE

$300,000 + $30,000 + $100,000 + $40,000 = **$470,000**. Check: EBIT $430,000 + D&A $40,000 = $470,000.

4.2 Adjusted EBITDA

Adjusted EBITDA also removes one-time items and replaces the owner's actual pay with what it would cost to hire a manager at a market salary. It is the earnings figure a buyer actually multiplies.

WORKED EXAMPLE

Line	Amount
EBITDA	$470,000
(+) One-time lawsuit settlement	$20,000
(+) Owner's salary and benefits	$150,000
(−) Market salary for a hired general manager	($110,000)
Adjusted EBITDA	**$530,000**

Illustrative.

4.3 What EBITDA leaves out

EBITDA is not cash flow. It ignores capital expenditures, changes in working capital, taxes and debt payments. In our example, EBITDA is $470,000 but free cash flow is $220,000. Warren Buffett made the point in his 2000 letter

to Berkshire Hathaway shareholders: “References to EBITDA make us shudder — does management think the tooth fairy pays for capital expenditures?” Lenders use cash flow after capital spending and taxes (Primer 3, DSCR), not EBITDA itself.

Adjustments can also be abused. Public companies that report EBITDA must reconcile it to the nearest accounting (GAAP) measure under the SEC’s Regulation G. A well-known stretch came from WeWork in 2018: its bond offering featured “community-adjusted EBITDA,” which excluded many of its core operating costs and was positive at about $233 million for 2017, while the company reported a net loss of about $933 million. The more an “adjusted” number excludes, the harder a buyer should look at it.

INTERVIEW QUESTIONS

Why is EBITDA used in valuation multiples?

It measures operating earnings before financing choices (interest), tax situations and non-cash accounting charges, so companies with different capital structures can be compared. It also pairs with enterprise value, which is the value to all funders.

What are the weaknesses of EBITDA?

It ignores capital spending, working capital needs, taxes and debt service, so it overstates cash for capital-heavy businesses, and “adjusted” versions can exclude real recurring costs.

5. SDE: Seller's Discretionary Earnings

5.1 The definition

> **SDE** is everything one full-time owner-operator could take out of the business in a year: pre-tax income plus the owner's salary and benefits, interest, depreciation and amortization, and one-time or discretionary expenses.

SDE is used for smaller, owner-run companies (roughly under $1 million of earnings), where the buyer will work in the business and the owner's pay is part of the return. EBITDA is used for larger companies with a management team.

5.2 SDE and adjusted EBITDA side by side

WORKED EXAMPLE

Line	SDE	Adjusted EBITDA
Pre-tax income	$400,000	$400,000
(+) Owner salary & benefits	$150,000	$150,000
(−) Market salary for a hired manager	—	($110,000)
(+) Interest expense	$30,000	$30,000
(+) Depreciation & amortization	$40,000	$40,000
(+) One-time lawsuit settlement	$20,000	$20,000
Total	**$640,000**	**$530,000**

The $110,000 gap is exactly the cost of replacing the owner. SDE assumes the buyer works in the business; adjusted EBITDA assumes someone is paid to.

Illustrative.

5.3 Why each add-back is there

Add-back	Why it is added back
Interest	Depends on how the current owner financed the business; the buyer will have their own debt
Taxes	Depend on the owner's tax situation and legal structure
Depreciation & amortization	Accounting charges for past purchases, not cash spent this year
One-time expenses	Will not happen again (a lawsuit, a one-off move)
Owner pay (SDE only)	The buyer decides what to pay themselves

5.4 Why every add-back matters for price

FORMULA

Change in price = Change in earnings × Multiple

Businesses sell at a multiple of earnings, so every add-back raises the price. A $20,000 add-back at 4.0x adds **$80,000** to the price. That is why buyers and the quality of earnings review (Primer 2) challenge every add-back, and why an EBITDA multiple must never be applied to SDE.

INTERVIEW QUESTIONS

What is the difference between SDE and EBITDA?

SDE includes the owner's full compensation, because it assumes the buyer will run the business. Adjusted EBITDA subtracts a market salary for a manager. SDE is used for small owner-run firms; EBITDA for larger companies with management.

A seller presents $640,000 of SDE and asks for 5.0x. What should you ask?

Whether 5.0x is an SDE multiple or an EBITDA multiple. At 5.0x SDE the price is $3.2M; if 5.0x is the market EBITDA multiple, the price should be based on $530,000 of adjusted EBITDA, or $2.65M. Then test each add-back.

KEY TAKEAWAYS

1. The income statement shows profit over time; the balance sheet shows position at a point in time; the cash flow statement reconciles the two through cash.

2. Accrual profit is not cash. Working capital and capital spending explain the difference.

3. Free cash flow, not net income, pays an acquisition loan.

4. EBITDA strips out financing, taxes and accounting charges so operations can be compared; adjusted EBITDA also normalizes owner pay and one-time items.

5. SDE is for small owner-run businesses and is always larger than adjusted EBITDA by the cost of a manager.

6. Every add-back is multiplied into the price, so every add-back must be proven.

Sources

1. U.S. Securities and Exchange Commission, Regulation G and Item 10(e) of Regulation S-K (conditions for use of non-GAAP financial measures)
2. WeWork Companies Inc., bond offering materials, April 2018, as reported by the Wall Street Journal and Bloomberg
3. Warren Buffett, Berkshire Hathaway Inc. letter to shareholders, 2000
4. Financial Accounting Standards Board, Accounting Standards Codification (accrual accounting and revenue recognition)
5. Standard accounting and finance concepts (the three statements, working capital, free cash flow, EBITDA, SDE) are general material not tied to a single source.

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