Commercial Awareness and the Firm

Interview preparation summary · AU track

IN THIS SUMMARY

- Clients and sectors
- The profession

INT.UM.1.a · Clients and sectors

Read a client's business model and a set of results, compute the key trends, and turn them into audit risks.

A client's business model answers four questions: who pays, for what, how the company delivers it, and how that turns into cash. An auditor reads a set of results through that model. Revenue growth is split into price, volume and new customers. Gross margin shows pricing power and cost control. Operating profit shows how overheads scale. Operating cash flow shows whether profit is turning into money. The quick tests are working capital days (inventory, receivables and payables), cash conversion (operating cash flow divided by operating profit) and whether every number moves in a direction the model explains. A number that moves against the model, for example inventory rising faster than sales in a fashion retailer, is where misstatement or trouble is most likely, and it tells the auditor which assertions to test. Interviewers ask this to see whether you can turn ratios into risks. A common mistake is to list ratios without saying what they mean. Another is to treat an unusual number as proof of error, when it is really a question to investigate.

WORKED EXAMPLE: READING CALDERBECK OUTDOOR FROM ITS RESULTS

Calderbeck Outdoor is an invented seller of camping and hiking equipment through 30 shops and a website. This year revenue was 120.0m (last year 108.0m), cost of sales 78.0m (67.5m), operating profit 9.6m (10.8m), operating cash flow 4.2m (11.4m), year-end inventory 24.0m (15.0m), trade receivables 12.0m (9.0m) and trade payables 13.0m (11.0m). Receivables come from its wholesale customers. The manager asks what the results say about the business and where the audit risk lies. Conventions: inventory and payables days use cost of sales, receivables days use revenue, all times 365; cash conversion is operating cash flow divided by operating profit.

Answer: Revenue is up 11.1% but margin and profit are down, cash conversion has fallen from 106% to 44%, and inventory days are up from 81 to 112. The main audit risks are inventory valuation and receivables recoverability.

> **Interview tip:** Say the model first (what the business sells and how it gets paid), then two or three computed trends, then what each could mean, then the audit risk. Finish by saying what you would ask management, so it is clear the numbers are questions and not conclusions.

INT.UM.1.b · Clients and sectors

Describe the audit risks typical of retail, banking and insurance, technology, manufacturing, public sector and charities, and say why each arises.

Each sector has a pattern of audit risk because its money flows and judgements differ. Retail: cash takings, inventory valuation and shrinkage, supplier rebates, leases and store impairment. Banking and insurance: loan impairment and claims reserves are large estimates where a small change in assumptions can exceed materiality, together with heavy dependence on IT systems and regulatory capital. Technology: revenue recognition on contracts with several elements, capitalised development costs and share-based pay. Manufacturing: inventory costing and counts, long-term contracts, asset lives and cut-off. Public sector and charities: no profit motive, so the pressures are budgets, grant conditions, restricted funds, completeness of donated income and public scrutiny. For each sector, an interviewer wants the risk, why it arises from the business, and one procedure that addresses it. The usual mistake is to give the same generic list (revenue and inventory) for every client, which shows you have not thought about how the business works.

WORKED EXAMPLE: HOW BIG IS A LOAN LOSS ESTIMATE FOR FENWICK SAVINGS?

Fenwick Savings is an invented bank. Gross loans are 2,400.0m, profit before tax is 90.0m, and management's allowance for expected credit losses is 1.5% of loans. The manager asks you why loan impairment is treated as the main risk area for a lender and how big the estimate is against materiality. Use 5% of profit before tax as an illustrative rule of thumb and ignore tax.

Answer: Loan impairment is large (36.0m) and a 0.3 point change in coverage moves profit by 7.2m, about 1.6 times materiality. So the auditor tests the data, the model and the assumptions, and looks for management bias.

> **Interview tip:** Contrast sectors in one breath: a retailer's risk is mostly physical stock and cash, a bank's is a judgement estimate that is large against materiality. Then give the sensitivity number, because it shows you understand why the estimate matters.

INT.UM.1.c · Clients and sectors

Recognise the warning signs that a business may fail and explain how an auditor assesses going concern.

Businesses rarely fail because profit is low on a single day. They fail because cash runs out or lenders stop lending. Warning signs include falling margins with rising inventory and receivables, profit that does not turn into cash, dependence on one customer or supplier, heavy debt with thin interest cover, covenants with little headroom, loans falling due without agreed refinancing, rapid growth funded by short-term borrowing (overtrading), and management forecasts that assume a sharp break from history. Auditors assess whether the company can continue for at least twelve months from the date the statements are approved, a period commonly used. They obtain management's forecast, test its assumptions, check facilities and covenants, ask what management could do if things go badly, and consider the effect on disclosures and the audit report if significant doubt remains. Interviewers want you to separate loss-making from running out of cash, and to test a forecast sceptically instead of accepting it.

WORKED EXAMPLE: WOULD MARLOWE PRINT WORKS SURVIVE THE LOSS OF A CUSTOMER?

Marlowe Print Works is an invented commercial printer. Revenue is 55.0m, EBITDA (earnings before interest, tax, depreciation and amortisation) is 7.5m, depreciation is 4.0m, interest is 2.8m and net debt is 33.0m. The bank loan requires net debt to EBITDA of no more than 4.5 times. Current assets are 14.0m and current liabilities 19.0m, including an 8.0m loan repayable within twelve months with no agreed refinancing. Its largest customer, 12% of revenue, has said it may move to another printer. The manager asks how worried to be. Assume a lost sale carries a 30% contribution margin and other costs are unchanged.

Answer: Headroom is only 0.17m of EBITDA, the 8.0m loan is due within a year, and losing the customer would take leverage to 6.0 times against a 4.5 limit. There is a real going concern question that depends on the bank's response and needs sceptical testing of the forecast.

> **Interview tip:** Show the sequence: how close to the limit, what could push it over, what happens next, and what evidence you would want. Avoid saying the company will fail; say what the evidence would need to show for the auditor to be comfortable.

INT.UM.2.a · The profession

Describe the structure of the audit market, explain why it is concentrated, and discuss the consequences for clients and regulators.

In many countries a small number of large international networks audit most of the biggest listed companies, with mid-tier networks and smaller firms covering the rest, including most private companies. The reasons: large clients need global coverage, specialist teams, systems, capacity to finish work in a tight reporting window, and the reputation and insurance to carry liability. Boards, lenders and investors find it safer to choose known names, and the large firms' share tends to persist. Concentration is measured by the combined share of the largest few firms (for example the top four) or by the sum of squared shares (the Herfindahl-Hirschman index). The debates: choice is thin for large clients, especially when some firms are conflicted by other services; the failure of one large network would be hard to absorb; challengers struggle to win big work. Policy ideas include mandatory tendering and rotation, joint audits and market share limits, each with costs. Interviewers want a balanced view and an understanding of the arithmetic, not a slogan.

WORKED EXAMPLE: MEASURING CONCENTRATION IN THE MARKET FOR LISTED COMPANY AUDITS

In the invented country of Alderland the audit fees of listed companies are shared as follows: Firm A 31%, Firm B 27%, Firm C 20%, Firm D 14%, and four smaller firms with 2% each. A newspaper says the market is dominated by a few firms. The interviewer asks you to measure concentration and say what would happen if Firm B stopped auditing listed companies and its clients moved to the others in proportion to their current shares.

Answer: The top four hold 92% and the index is 2,302, which is concentrated. If one large firm left, the index would rise to about 2,952 and the remaining large firms would have to absorb a lot of work, which is why regulators worry about resilience as well as choice.

> **Interview tip:** Name the measure in plain words first (the share held by the top four), then the index, then the point that matters to clients: choice and resilience. Keep it balanced and avoid naming real firms.

INT.UM.2.b · The profession

Explain what audit quality means, how it can be assessed, and the main arguments in debates on audit reform.

Audit quality is whether the auditor obtains enough appropriate evidence, reaches sound conclusions and reports what was found. It is not the number of hours worked or whether the client is pleased. Indicators include the time senior people spend on the file, review of key judgements, consultation on difficult matters, training, staff turnover, the results of internal and independent inspections, and later restatements. At overview level the reform debates are these. Rotation and tendering: a fresh perspective against loss of accumulated knowledge. Separating audit from advisory: fewer conflicts against loss of skills and information. Fee pressure: cheap audits risk thin work. Fraud and going concern: clearer reporting on what the auditor did, to narrow the expectation gap. Oversight by an independent regulator and the use of technology. Present these as debates without settled answers. The usual mistakes are to claim that one reform would fix quality, or that an audit can find all fraud.

WORKED EXAMPLE: WHAT DOES A FEE CUT DO TO AN AUDIT BUDGET?

An invented engagement team for Corran Foods plans 3,400 hours with a standard charge-out value of 612,000 (an average of 180 per hour). The agreed fee is 540,000. Next year the audit committee asks for a 5% lower fee for the same work. The interviewer asks what this does to the economics and how audit quality could be affected. Convention: recovery is fee divided by the standard value of the hours.

Answer: A 5% fee cut on an 88.2% recovery means either 83.8% recovery at the same hours or about 170 fewer hours. Quality is protected by cutting waste, not review of key judgements.

> **Interview tip:** Show you understand the commercial pressure and the quality risk at once. Give the numbers briefly, then say where hours may fairly come from and where they must not.

INT.UM.2.c · The profession

Describe the other service lines of a professional services firm, explain how they affect independence, and discuss a current development in a structured way.

Large firms are multi-service: audit and assurance, tax, advisory (consulting, risk, technology) and deal advisory (due diligence, valuation, restructuring). Smaller firms offer a similar range at a smaller scale. This matters for careers, for the economics of the firm and for independence. Services to audit clients can create self-review, advocacy and self-interest threats. Many regimes restrict some services and may cap non-audit fees against audit fees; practice varies by jurisdiction, and a firm's own policy comes on top. Commercial awareness also means discussing a current development: a regulatory change, a sector under strain, AI, sustainability reporting. A good structure is one sentence on what it is, why it matters to clients or auditors, a balanced view with its limits, and one implication for a trainee. Read the financial press, the professional body's news, the firm's published reports and the annual reports of sectors you want to audit. The usual mistake is reciting headlines without a view or without admitting what you do not know.

WORKED EXAMPLE: CHECKING A NON-AUDIT FEE REQUEST AGAINST A POLICY CAP

A firm audits the invented listed company Hallam Logistics. Its audit fees (in thousands) for the last three years were 600, 640 and 680. The firm's own policy, in this example, limits annual non-audit fees to 70% of the average audit fee over three years. The firm already earns 300 a year from tax compliance work for Hallam, and Hallam now asks the advisory team to carry out a 180 review of its pricing process. A trainee is asked whether the firm can accept. Firm policy comes on top of whatever the law of the jurisdiction requires.

Answer: Total non-audit fees of 480 exceed the cap of 448 by 32, so the firm should decline or reduce the project, and should also consider the self-review threat before accepting any part of it.

> **Interview tip:** Do the calculation quickly and out loud, then move to judgement: a number inside the cap is necessary, not sufficient. Say that rules vary by jurisdiction and that you would follow the firm's policy and ask a more senior colleague.