CHARTA LEARNING · INTERVIEW PREPARATION

Financial Reporting for Auditors

Interview preparation summary · AU track

IN THIS SUMMARY

- The statements
- Judgement areas

INT.UR.1.a · The statements

Explain how the income statement, balance sheet and cash flow statement link, and use double-entry to show what a transaction does to each of them.

The three statements are one set of numbers seen three ways. The income statement measures profit for a period, the balance sheet lists assets, liabilities and equity at a date, and the cash flow statement explains why cash changed. They link at fixed points: profit less dividends adds to retained earnings, closing cash in the cash flow statement equals cash on the balance sheet, and depreciation and the changes in receivables, inventory and payables bridge profit to operating cash flow. Double-entry is the machinery. Every transaction has equal debits and credits, so assets always equal liabilities plus equity. Debits increase assets and expenses; credits increase liabilities, equity and income. An auditor uses this to follow a transaction through the records and to see what a wrong entry does elsewhere. A balance sheet that balances proves little, because an entry posted to the wrong account of the same kind still balances. Interviewers want you to explain why profit and cash differ and to state the effect of one entry on all three statements.

WORKED EXAMPLE: FENNIMORE CYCLES: ONE YEAR IN SIX ENTRIES

Fennimore Cycles Ltd is an invented bicycle retailer in its first year. Shareholders put in 50,000 cash. It buys inventory of 30,000 on credit, sells goods that cost 18,000 for 40,000 on credit, collects 25,000 from customers, pays suppliers 20,000, pays 9,000 of wages in cash and buys equipment for 12,000 cash, depreciated over four years. Ignore tax. Work out profit, the balance sheet, and cash flow from operations, and say why profit and operating cash differ.

Answer: Profit is 10,000, total assets are 70,000, and operating cash flow is -4,000. The 14,000 gap is working capital: receivables and inventory rose by 27,000 and payables funded 10,000 of it, with depreciation adding back 3,000.

> **Interview tip:** Walk the entries in order and finish with the bridge from profit to cash. Say that a balancing balance sheet is a check on arithmetic, not on whether each entry was right.

INT.UR.1.b · The statements

Apply the five-step revenue model at overview to a contract with more than one promise, and say how much revenue is recognised in the year and what is left as a contract liability.

Under IFRS 15, and broadly the same way under US GAAP, revenue is recognised when a customer obtains control of what was promised, not when cash arrives or an invoice is raised. The five steps are to identify the contract, identify the separate promises (performance obligations), determine the transaction price, allocate it to the promises in proportion to their stand-alone selling prices, and recognise revenue as each promise is satisfied, either at a point in time (goods delivered, a licence handed over) or over time (a subscription, a service, construction measured by progress). Three judgements matter most to an auditor: whether promises are distinct, the estimate of progress or variable consideration such as expected returns, and whether the company acts as principal (gross) or agent (net). Cash received before delivery is a contract liability, not revenue. The usual mistake is booking the whole bundle at signing or billing. Interviewers want you to allocate before you recognise.

WORKED EXAMPLE: CALDER SOFTWARE: A LICENCE, SUPPORT AND SET-UP SOLD TOGETHER

Calder Software Ltd, an invented company with a 31 December year-end, signs a contract on 1 October for a software licence, 12 months of support and implementation work, for a total price of 880,000, paid in full on 1 October. Stand-alone selling prices are 600,000 for the licence, 150,000 for support and 250,000 for implementation. The licence is a right to use the software, handed over on 1 October. At 31 December the implementation is 60% complete. Treat the three promises as distinct. How much revenue is recognised in the year and what is the contract liability at the year-end?

Answer: Revenue for the year is 693,000 and the contract liability is 187,000. Booking the whole 880,000 on signing would overstate revenue by 187,000.

> **Interview tip:** Say allocate, then recognise, then compare with cash. Always name the judgement that moves the number most, here the progress estimate.

INT.UR.1.c · The statements

Estimate a loss allowance for receivables using an ageing and loss rates, and value inventory at the lower of cost and net realisable value item by item.

Receivables and inventory are where optimism hides in the balance sheet. Under the expected credit loss model in IFRS 9, a company provides for losses it expects, using history adjusted for current conditions and forecasts, rather than waiting for a default. For trade receivables the usual tool is a provision matrix: an ageing by bucket multiplied by a loss rate for each, with known problem customers assessed individually. The allowance is a balance sheet figure, and the income statement charge is the closing allowance less the opening allowance plus amounts written off. Inventory is carried at the lower of cost and net realisable value (NRV), which is the expected selling price less costs to complete and sell. The test is item by item, so a gain on one line cannot offset a loss on another, and reversals are limited to the original write-down. Auditors test rates against history and cash received after the year-end, and ageing accuracy. The usual mistake is applying one flat percentage. Interviewers want a calculation and a challenge to the assumption.

WORKED EXAMPLE: ASHDOWN WHOLESALE: A PROVISION MATRIX AND ONE STOCK LINE

Ashdown Wholesale Ltd is an invented food distributor. Receivables are 6,000,000 current at a loss rate of 0.5%, 2,400,000 up to 30 days overdue at 2%, 1,000,000 at 31-60 days at 6%, 500,000 at 61-90 days at 15% and 300,000 over 90 days at 40%. The opening allowance was 290,000 and 40,000 of debts were written off in the year. Separately, a stock line cost 150,000 and is expected to sell for 170,000 with 28,000 of selling costs. Work out the allowance, the charge for the year and any inventory write-down.

Answer: The allowance is 333,000 (3.3% of receivables), the charge is 83,000 and the stock write-down is 8,000.

> **Interview tip:** State the closing allowance first, then the charge, and say you would test the rates against history rather than accept a single percentage.

INT.UR.2.a · Judgement areas

Account for a lease as a lessee at overview, and explain how property, plant and equipment is capitalised, depreciated and re-estimated.

Under IFRS 16 a lessee records almost every lease on the balance sheet at the start: a lease liability equal to the present value of the payments, discounted at the rate in the lease or the company's borrowing rate, and a matching right-of-use asset. Afterwards, interest accrues on the liability and each payment reduces it, while the asset is depreciated, usually straight-line over the lease term. The expense is front-loaded compared with rent, and EBITDA rises because rent becomes depreciation and interest. Exemptions cover short leases and low-value assets, and the lease term, including renewal options the company is reasonably certain to use, is a key judgement. US GAAP also puts leases on the balance sheet but, in many cases, keeps a single straight-line lease cost for operating leases. Property, plant and equipment is capitalised at cost including directly attributable costs, depreciated over its useful life to residual value, and changes in life or residual value are applied from then on, not restated. Repairs are expensed. The usual mistake is capitalising repairs or ignoring renewal options.

WORKED EXAMPLE: MARLOW RETAIL: A FIVE-YEAR STORE LEASE

Marlow Retail Ltd, an invented clothing chain, signs a five-year store lease on 1 January. Rent is 100,000 a year paid at each year-end and the discount rate is 6%. The annuity factor for five years at 6% is 4.21236. Calculate the opening lease liability and right-of-use asset, the first-year interest, the depreciation, the first-year expense, and the liability at the end of year one.

Answer: Opening liability and asset are 421,236, the year-one expense is 109,521, and the liability at the end of year one is 346,510.

> **Interview tip:** Say present value first, then interest and depreciation, and finish by saying EBITDA rises and debt-like liabilities appear. Mention that the lease term is the judgement to test.

INT.UR.2.b · Judgement areas

Test an asset or a cash-generating unit for impairment, allocate any loss, and decide whether a legal or similar obligation needs a provision, a disclosure or nothing.

An asset must not be carried above what the business can recover from it. Impairment is tested when there is an indicator, and every year for goodwill: the carrying amount is compared with the recoverable amount, the higher of fair value less costs of disposal and value in use (the present value of future cash flows from continuing to use it). Any shortfall is a loss, taken first against goodwill and then across the other assets pro rata. Under IFRS a loss on assets other than goodwill can be reversed later; goodwill never; US GAAP generally does not allow reversals. Value in use rests on forecasts, a growth rate and a discount rate, so small changes in the last two move the answer a lot, and auditors test the headroom. Provisions follow a three-part test: a present obligation from a past event, a probable outflow (more likely than not), and a reliable estimate. A possible but not probable obligation is a contingent liability and is disclosed, not provided. The usual mistake is provisioning for a future intention.

WORKED EXAMPLE: HARTWELL FOODS: A BAKERY THAT MAY BE WORTH LESS THAN ITS BOOKS

Hartwell Foods plc is an invented food group. Its bakery cash-generating unit has goodwill of 0.6m, property, plant and equipment of 3.9m and other net assets of 0.5m, so a carrying amount of 5.0m. A competitor's entry is an impairment indicator. Value in use is 4.1m and fair value less costs of disposal is 3.8m. Other net assets are carried at amounts set by other standards and are not reduced. Find the loss and allocate it, then restate yearly depreciation if the plant has six years left.

Answer: The loss is 0.9m, all of the goodwill (0.6m) and 0.3m of plant, and yearly depreciation falls from 0.65m to 0.60m.

> **Interview tip:** Give recoverable amount, then the loss, then the order of allocation. Add that the value in use is only as good as the forecast and discount rate.

INT.UR.2.c · Judgement areas

Explain how a group is consolidated, calculate goodwill and non-controlling interest, eliminate an intragroup profit, and describe deferred tax, financial instrument classification and the main IFRS and US GAAP differences at overview.

A parent consolidates every entity it controls, adding the subsidiary's assets, liabilities, income and expenses line by line, then removes the parent's investment against the subsidiary's equity. Goodwill is the price paid plus the non-controlling interest (NCI) less the fair value of identifiable net assets acquired. Under IFRS the NCI may be taken at its share of net assets or at fair value, which changes goodwill, and US GAAP generally uses fair value. Sales and profits between group companies are removed, including profit in stock still held by the buyer. Deferred tax arises from temporary differences between carrying amount and tax base, such as faster tax depreciation, and is measured at the expected tax rate. Financial instruments are classified by the business model and the cash flows: held to collect principal and interest means amortised cost, and most other items are at fair value. Common differences, stated generally: LIFO is allowed under US GAAP and not under IFRS, and IFRS capitalises development costs when criteria are met while US GAAP usually expenses them. The usual mistake is forgetting the intragroup elimination.

WORKED EXAMPLE: SABLE COMPONENTS: BUYING 80% AND SELLING TO IT

Orchard Group plc, an invented group, pays 12.0m in cash for 80% of Sable Components Ltd. The fair value of Sable's identifiable net assets is 9.0m. The NCI is measured at its share of net assets, and alternatively at a fair value of 2.7m. After the purchase Sable earns a profit of 2.0m. In the same year Orchard sold goods that cost it 0.7m to Sable for 1.0m, and half of them remain in Sable's stock at the year-end. Work out goodwill under both bases, the NCI share of the profit and the profit to eliminate.

Answer: Goodwill is 4.8m (or 5.7m with NCI at fair value), the NCI takes 0.4m of the profit, and 0.15m of unrealised profit is eliminated.

> **Interview tip:** Say the goodwill formula once, state which NCI basis you used, and always mention the intragroup elimination. Say how you would check the fair values behind the acquisition.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.