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AUDIT RISK AND MATERIALITY

Adv Cases in Assurance Services (ACCTG 521)

Class 4 | MPAcc class of 2025

Agenda

Review

Audit Risk and Planning

- Overview
- Qualitative Exercise: Identify Risks & Classify Accounts
- Materiality Discussion
- Semi-Quantitative / Qualitative Assessments of Materiality
- Dynamic Audit Planning Exercise

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Review

- Conflicting incentives for firms to disclose and withhold information
- Conflicting incentives for firms to undertake audits (or information verification)
- Factors that influence demand for audit and therefore audit fee include:
  - Agency conflicts
  - Information asymmetry
  - Risk of intentional manipulation
  - Risk of unintentional errors

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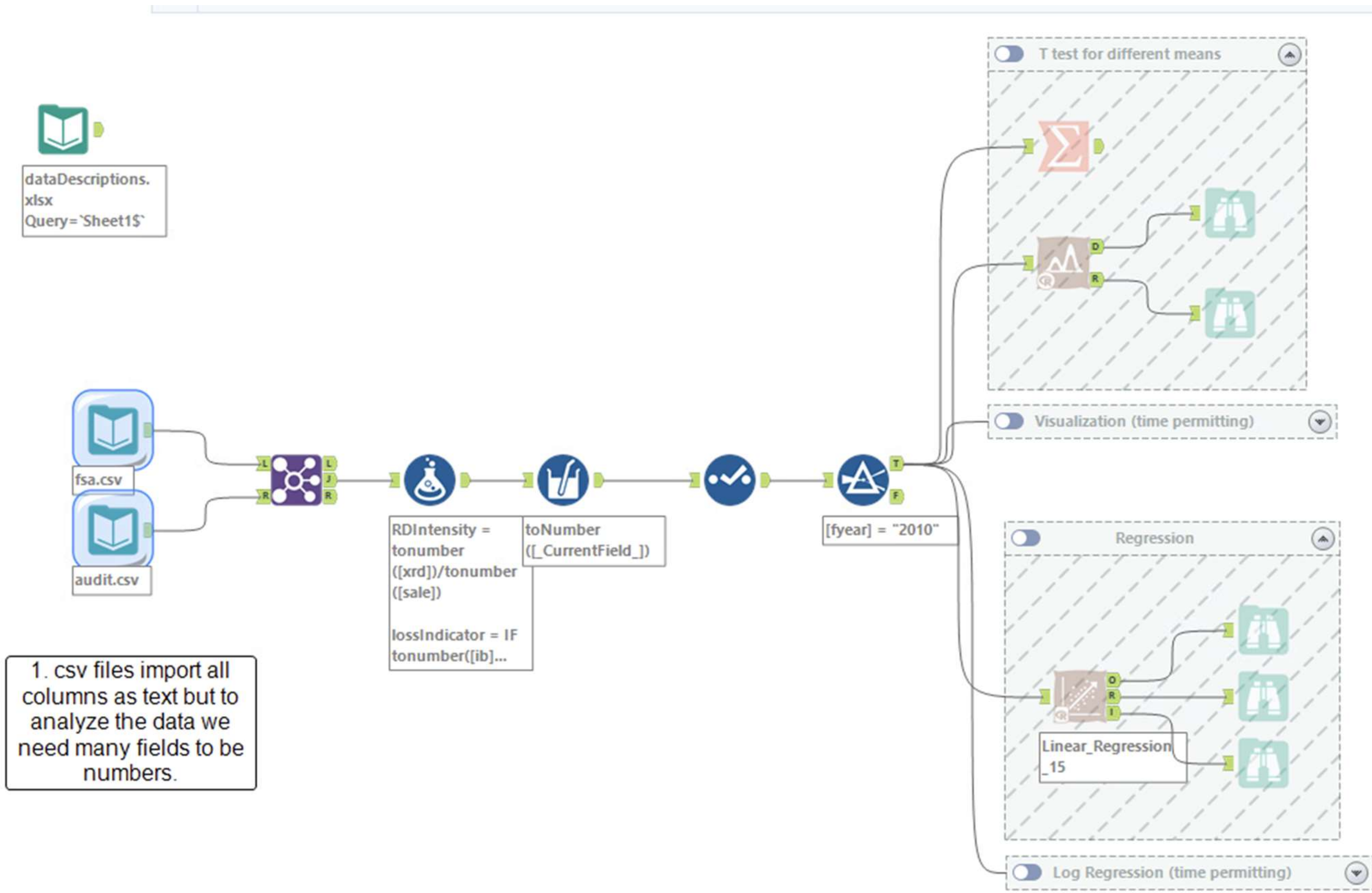
T test for different means
dataDescriptions.
xlsx
Query=`Sheet1$`
fsa.csv
audit.csv
RDIntensity =
tonumber
([xrd])/tonumber
([sale])
lossIndicator = IF
tonumber([ib]...
toNumber
([_CurrentField_])
[fyear] = "2010"
Visualization (time permitting)
Regression
Linear_Regression
_15
Log Regression (time permitting)
1. csv files import all
columns as text but to
analyze the data we
need many fields to be
numbers.

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Audit Risk and Planning: Overview

Audit Risk Model

Audit Risk: risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated

$$AR = \underbrace{IR \times CR}_{RMM} \times DR$$

- **Inherent Risk**: risk that a management assertion is materially misstated (before considering internal controls)
- **Control Risk**: risk that internal controls fail to detect a misstatement
- **Detection Risk**: risk that auditors fail to detect a misstatement

Identifying Significant Accounts

AS 2110 – To identify significant accounts and disclosures and their relevant assertions, auditors should consider:

- Size and composition of the account
- Susceptibility to misstatement due to error or fraud
- Volume of activity, complexity, and homogeneity of individual transactions
- Nature of the account and disclosure
- Accounting and reporting complexities
- Exposure to losses
- Possibility of significant contingent liabilities
- Existence of related party transactions
- Changes from prior period

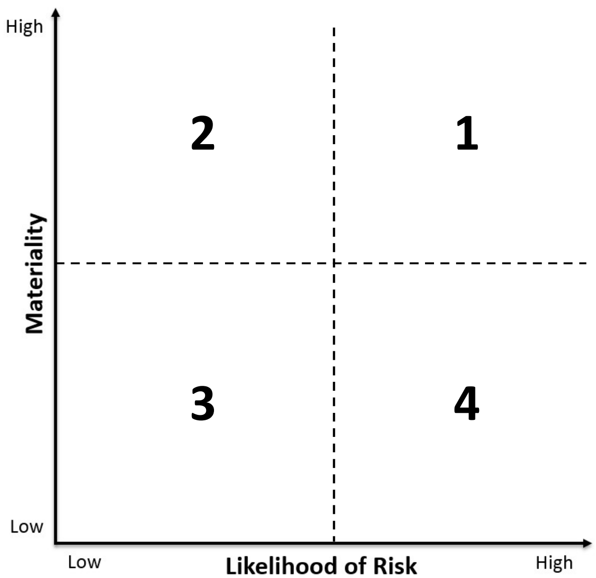
Business Risk: Auditor's Perspective

AS 2110 – during the planning phase of the engagement, auditors should obtain an understanding of the company and its environment, including:

- The nature of the company
- Objectives and strategies and related business risks that might reasonably be expected to result in risks of material misstatement
- Relevant industry, regulatory, and other external factors
- Selection and application of accounting principles and related disclosures
- Measurement and analysis of financial performance

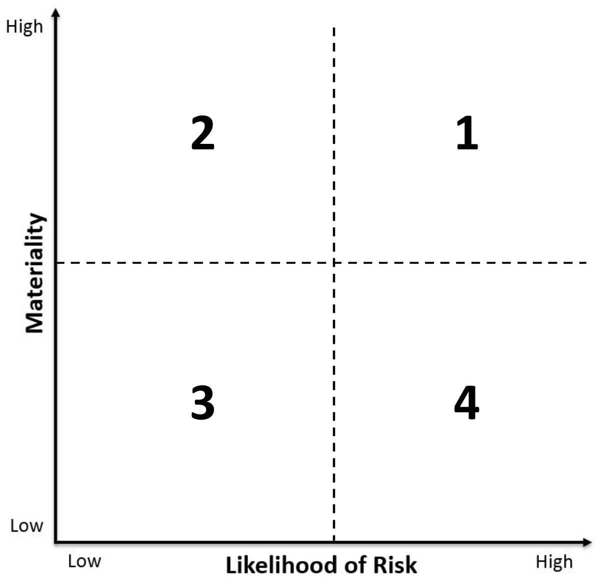
Misstatement Risk

Function of Materiality and Probability



Group Exercise – part 1

Applying the misstatement risk framework to the company selected by your group:



1. Prepare a brief 30-second overview of your company's business (nature, objectives, strategies) for the class.

2. Identify 1 account that falls into each of the 4 categories. Where does it fall within the quadrant, **and why**? In other words, assess the materiality and likelihood of risk associated with the account.

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P	E	S	T	L	E
Stability of government, corruption, trade restrictions, potential changes to legislation, global influences,	Economic growth, Employment rates, Inflation rates, Monetary policy, Consumer confidence	Income distribution, Demographic influences, Lifestyle factors	Changes in information technology, Disruptive technology, Take up rates	Taxation policies, Employment laws, Industry regulations, Health and Safety	Environmental Regulation, restrictions and sanctions, Customer attitudes

Required Risk Disclosures

Item 1a – Companies are required to disclose "the most significant factors that make an investment in a registrant's securities speculative or risky"

- Broad definition with little authoritative guidance
- Examples provided by SEC (unchanged since 1964): lack of operating history, lack of profitability in recent periods, financial position, businesses or proposed businesses, lack of market in the company's securities
- Boilerplate or relevant information?
- Listed in order of significance

Required Risk Disclosures

Critical Accounting Policies/Estimates (CAPs) – companies should consider whether they have made accounting estimates or assumptions where:

- Nature of estimates/assumptions is material due to levels of **subjectivity**, **judgment**, and **uncertainty**
- The impact of the estimates and assumptions is **material**

If so, the company should disclose in CAPs section of MD&A

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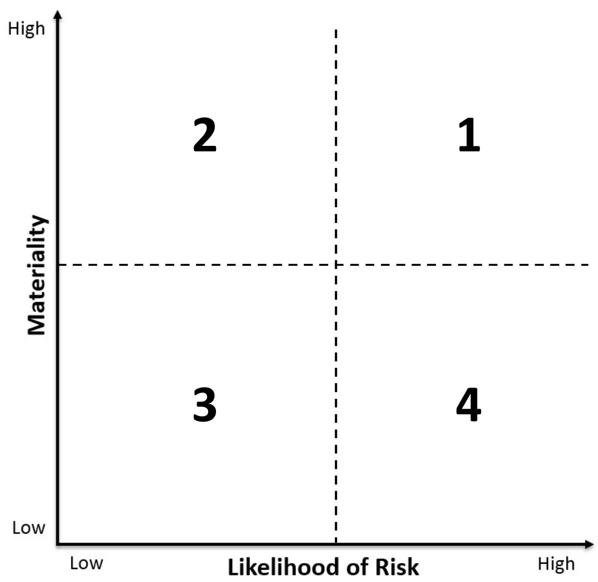

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Materiality

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What is Materiality?

AS 2105.03: "… the auditor should plan and perform audit procedures to detect misstatements that, individually or in combination with other misstatements, would result in material misstatement of the financial statements."

SAB 99: "a fact is material if there is a substantial likelihood that the … fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of the information made available."

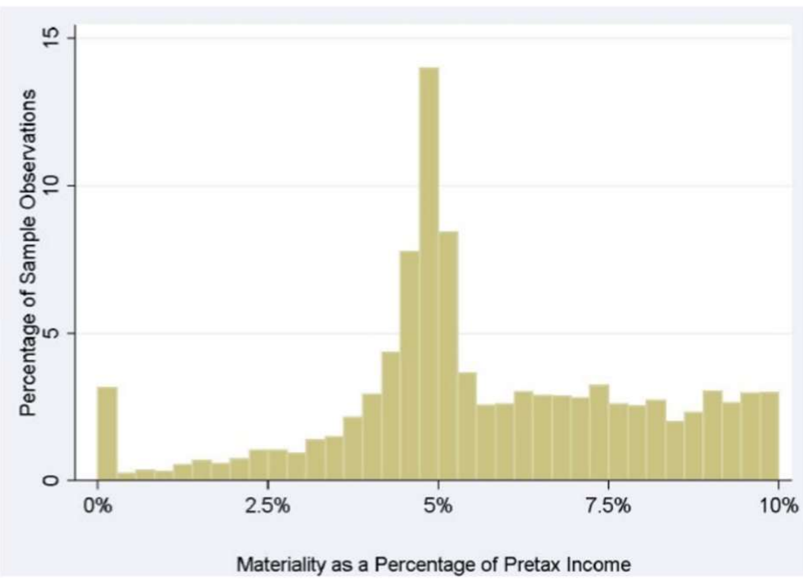
i.e., ***Influences the economic decisions of users***

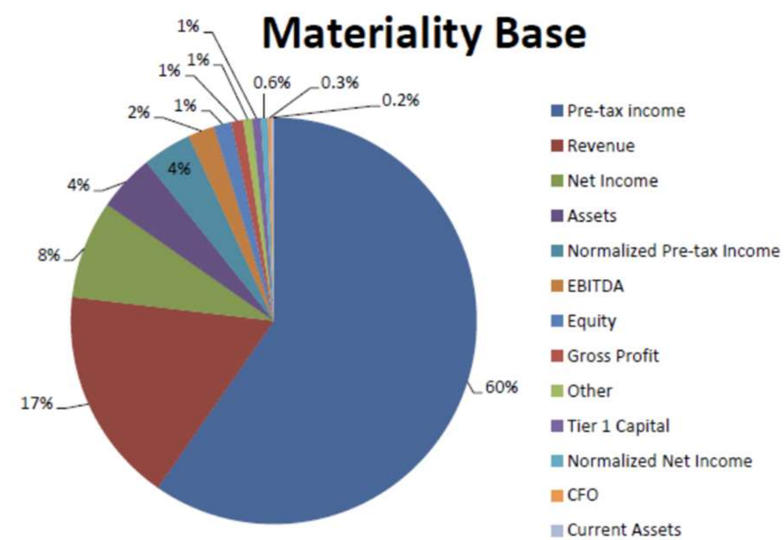
How do we translate this to numbers?

What the data suggests:

(Choudhary, Merkley, Schipper 2018)

Examine actual materiality estimates used in audits of US public firms. PCAOB data, so audits subject to PCAOB inspection. 4,284 observations; 2,150 audit clients, 8 audit firms, 2005-2014





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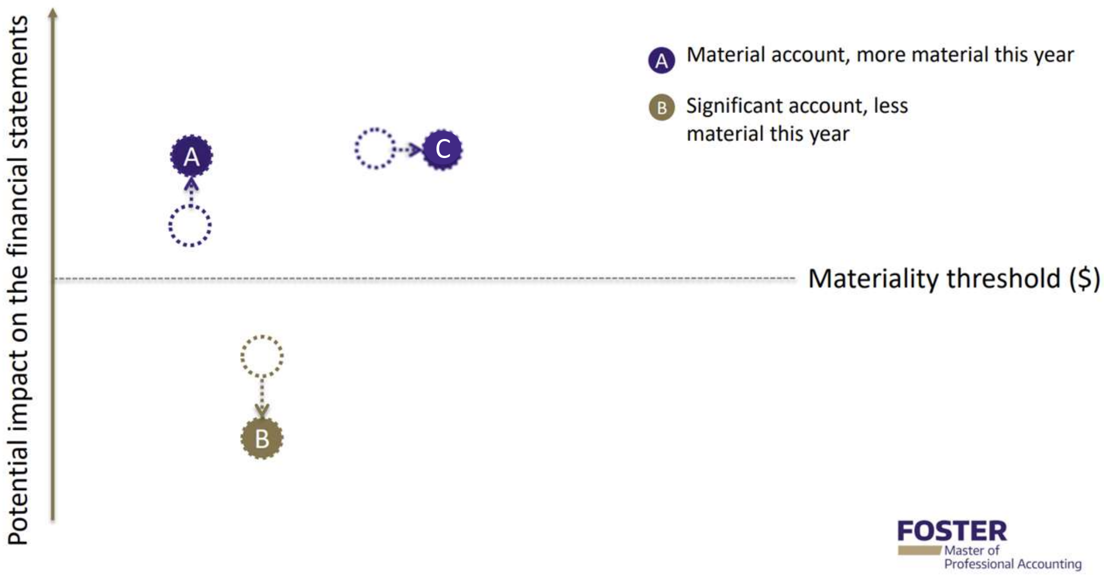
Group Exercise – part 2



1. Remind the class of your company.

2. Identify 3 material accounts that you can provide reasons for a potential change in risk, either becoming more material or more risky (e.g., C). Explain why for each account.

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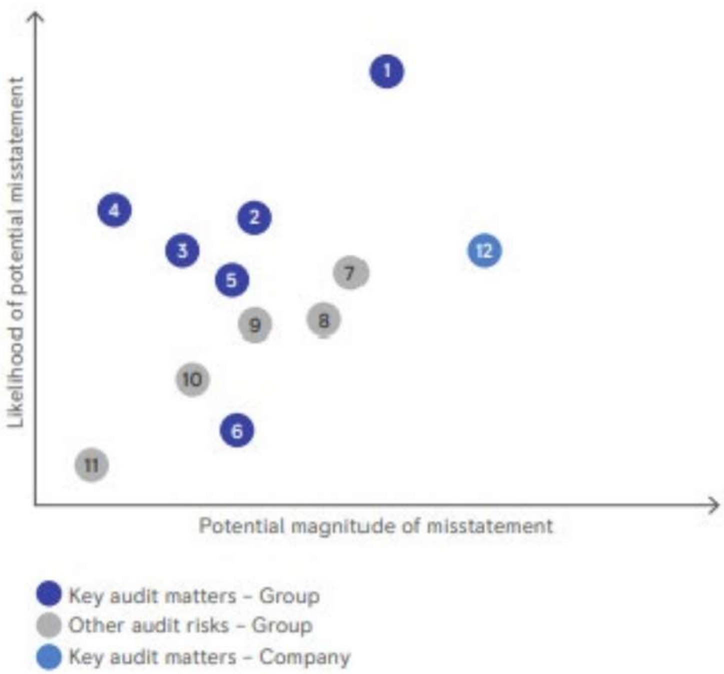
Dynamic Audit Planning - Viz



	Risks	Change from prior year
Key audit matters – Group		
1	Long-term contract accounting and associated provisions	<>
2	The recognition of deferred tax assets	<>
3	Presentation of underlying results and disclosure of other one-off items (including exceptional items)	<>
4	Translation of foreign currency denominated transactions and balances	<>
5	Response of the Group to the deferred prosecution and leniency agreements in connection with alleged bribery and corruption in overseas markets	↓
6	Implementation of IFRS 16	new
Other audit risks – Group		
7	Accounting for complex treasury instruments	<>
8	Measurement of post-retirement benefits	<>
9	Recoverability of programme assets	↓
10	Consolidation process and joint venture accounting	<>
11	Uncertain tax positions	<>
Key audit matters – Company		
12	Recoverability of the Company's investments in subsidiary undertakings	new

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You can use any tool, either powerpoint or something like LuidChart (free – login with Google)

https://lucid.app/lucidchart/e75991e8-da6e-4677-a99e-03b270f61b8a/edit?viewport_loc=-11%2C-11%2C4235%2C1571%2C0_0&invitationId=inv_1d94e63f-ab4e-45d3-afd9-5ded49aace08

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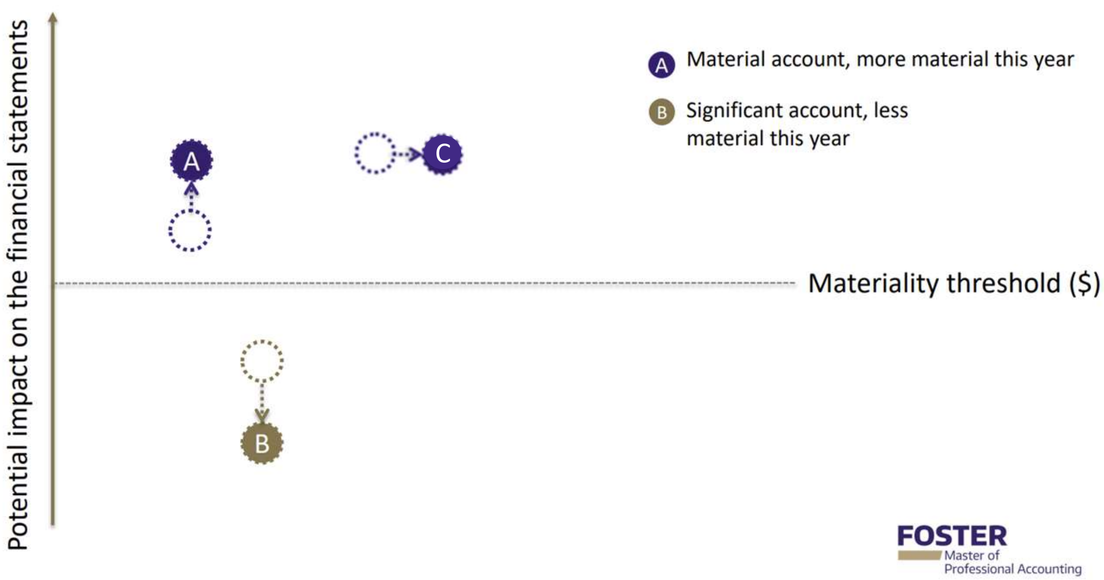
Group Exercise – part 2



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THANK YOU

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