

FOSTER

Master of
Professional Accounting



MISSTATEMENT RISK

(AND INTERNAL CONTROLS)

Advanced Cases in Assurance Services (ACCTG 521)
Class 5 | MPAcc class of 2025



Agenda

Review

Overview

- Misstatement Risk
- Internal Controls

Labs

- Factors associated with Restatements
- Factors associated with Internal Control Weaknesses (time permitting)

Economics of Audit

- Conflicting incentives for (i) firms to disclose and withhold information and (ii) 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
 - For example, firm size (i.e., total assets)



dataDescriptions.
xlsx
Query='Sheet1\$'



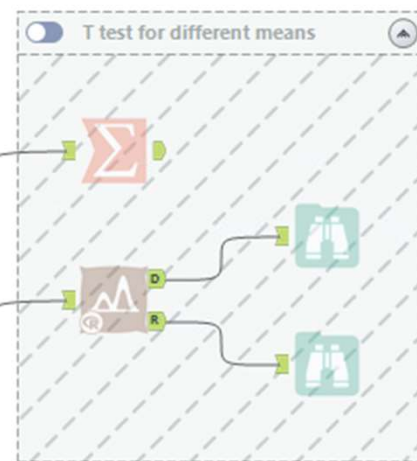
1. csv files import all
columns as text but to
analyze the data we
need many fields to be
numbers.

RDIntensity =
tonumber
([xrd])/tonumber
([sale])

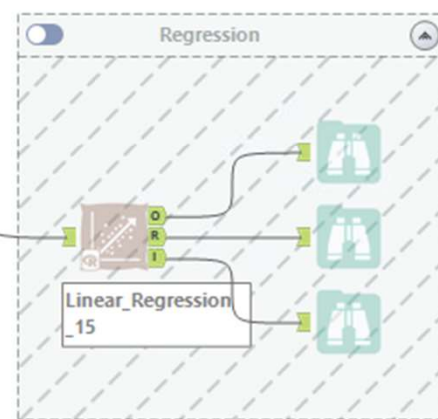
lossIndicator = IF
tonumber([ib]...

toNumber
([_CurrentField_])

[fyear] = "2010"



☐ Visualization (time permitting)



☐ Log Regression (time permitting)

Audit Risk Model

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

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

- **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

Audit Planning

- Assessment of business risks is fundamental to thoughtful planning and execution of the audit.
- Business risks provide helpful starting point for assessing financial statement risks.
- Firm disclosures are helpful but can also contain boilerplate information or inconsistencies. Consider broad sources.
- Materiality is judged by whether the information would change the decision of a reasonable investor
- Materiality is based on qualitative and quantitative factors. It is ***subjective*** and requires judgment, but it is a critical starting point for understanding where to focus audit planning attention.

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What is a Misstatement? (AS2810.A2)

"A misstatement, if material individually or in combination with other misstatements, causes the financial statements not to be presented fairly in conformity with the applicable financial reporting framework. **A misstatement may relate to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item** and the amount, classification, presentation, or disclosure that should be reported in conformity with the applicable financial reporting framework. Misstatements can arise from error (i.e., unintentional misstatement) or fraud."

Material Misstatements

- Material misstatements will cause a firm to **restate** their financial statements.
- Many restatements are publicly announced in an 8-K.

Market response to restating firm



- Average abnormal returns below negative 9%
- Why might investors perceive a restatement as bad news?

Impact on auditor of a client restatement

- Auditors face a higher likelihood of litigation when a client restates
 - increasing for common frauds
 - and those including fictional transactions

Who do you expect brings legal action against the auditor? And why?

Impact on management of a misbehavior-related restatement

- Firms with a misbehavior-related restatement had higher turnover in 13 months around restatement
 - 49% of CEOs vs only 8% for error-related restatement
 - 64% of CFOs vs only 12% for error-related restatement
 - 91% of misbehavior restatements had either CEO or CFO leave (Hennes, Leone, and Miller 2008)
- More on misbehavior vs error related restatement:
 - Market reaction is -14% for misbehavior restatement, -2% for error-related restatement
 - 80% of misbehavior has a class action lawsuit, while only 1% of error did

What firm characteristics might predict restatement risk?

Firm Characteristic	Measures	+ / - ?	Why?
Accruals	ChgRec, ChgInv, RSST accruals, % soft assets		
Firm Performance	ChgROA, ChgCashSales		
Abn chg in # employees	AbnChgEmp		
Off-balance sheet information	OperLeases		
Stock / Debt market incentives	IssueDebtEquity		
Growth expectations	StockReturns, BooktoMarket		

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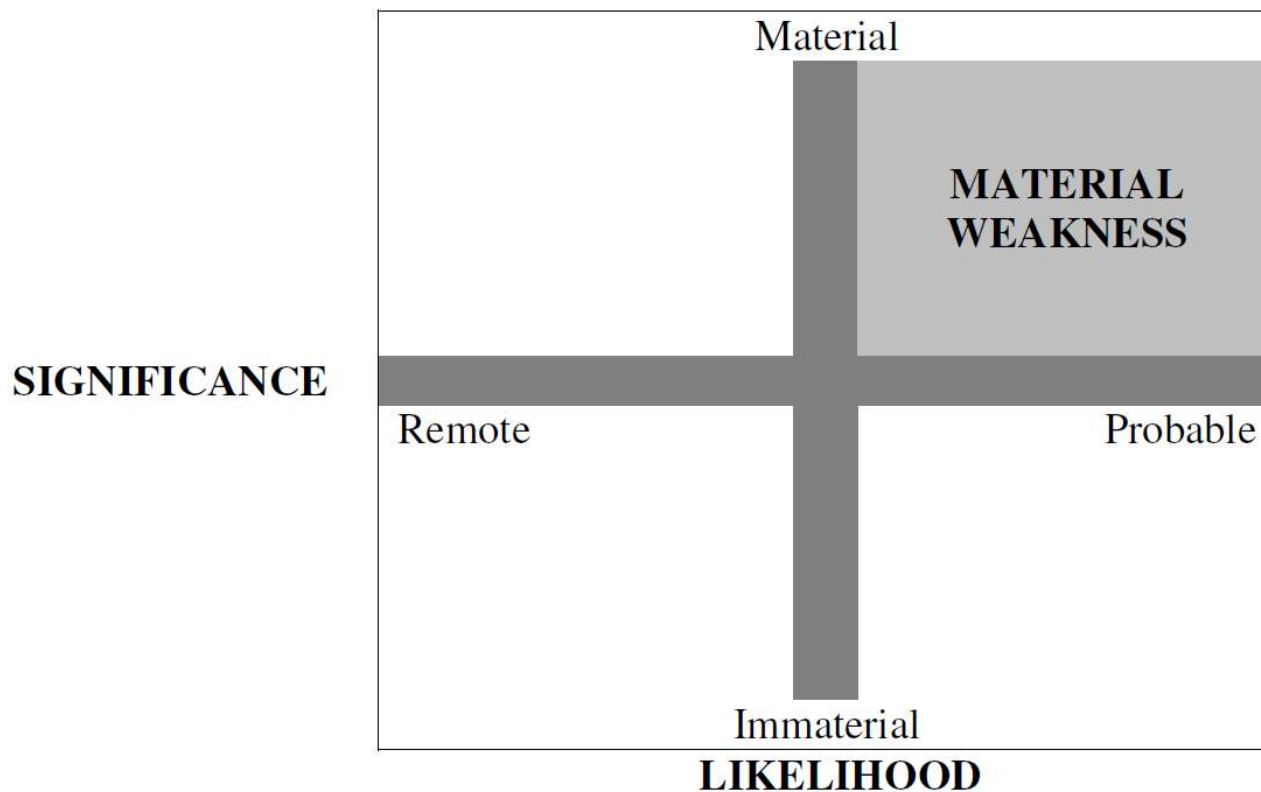
- Misstatement Risk
- **Internal Controls**

Labs

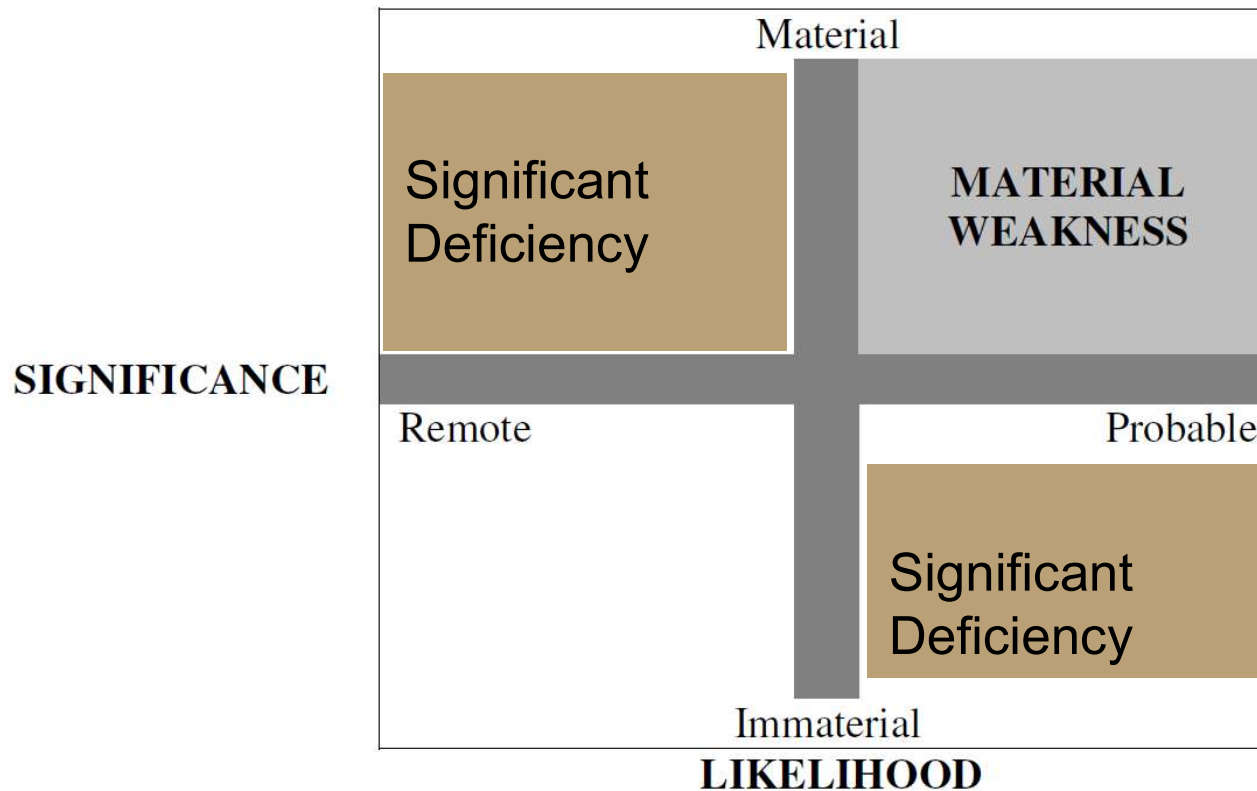
- Factors associated with Restatements
- Factors associated with Internal Control Weaknesses (time permitting)

What is a material weakness?

FIGURE 1
Internal Control Deficiency Evaluation



What is a significant deficiency?



- Material weaknesses need to be disclosed in the 10-K under Section 302 (and 404)
- Significant deficiencies do not need to be publicly disclosed, but must be disclosed to the audit committee

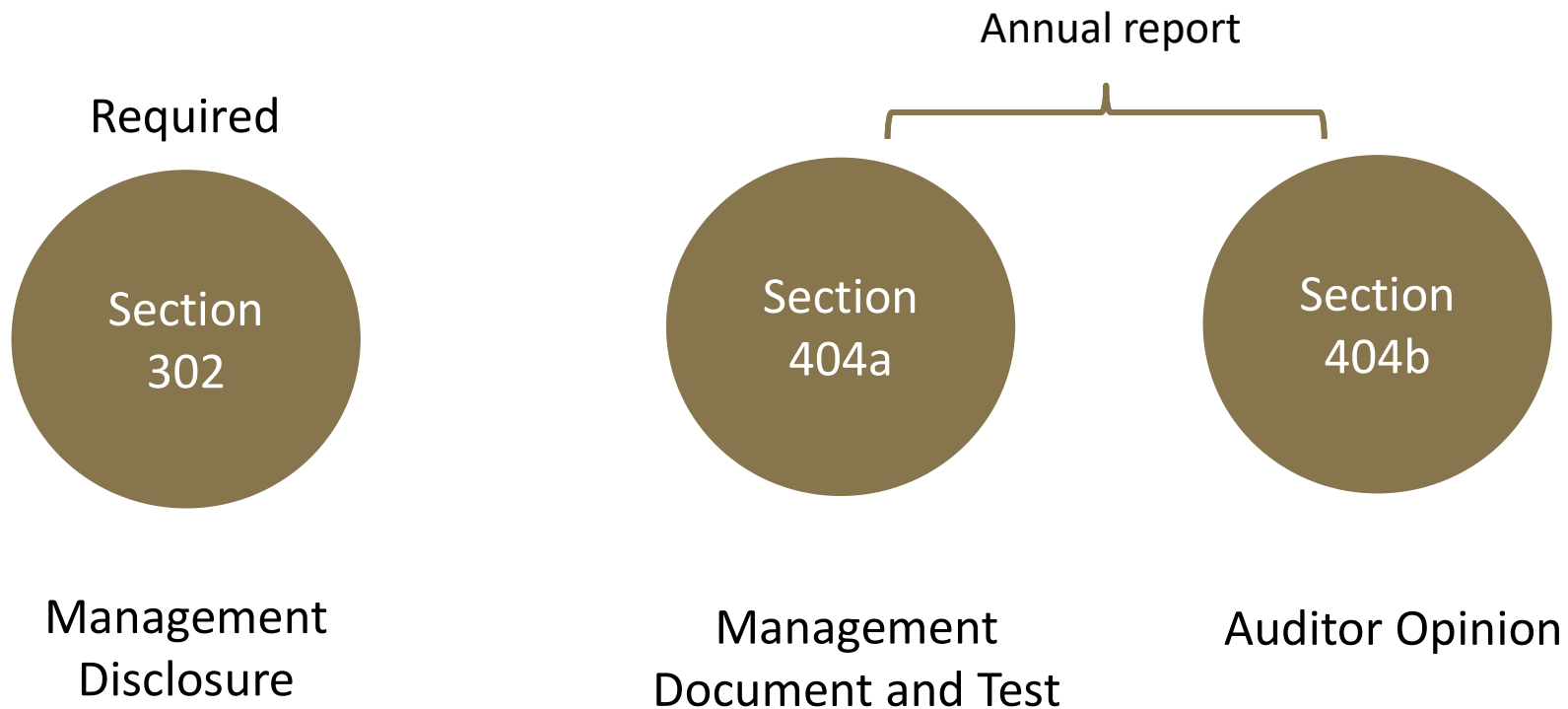
How does this all work?

- Example: Material weakness over allowance for doubtful accounts.
 - A firm does not have a policy for estimating allowance for doubtful accounts, instead just using last year's percentage as the estimate.
 - If the credit-worthiness of the client base has worsened (e.g., because salespeople are trying to meet quotas, or because there is a systematic shock such as the financial crisis), then the allowance for doubtful accounts will be too low and could result in a misstatement.

How does this all work?

- Example: Material weakness over inventory tracking.
 - A firm does not have an inventory tracking system.
 - When the inventory is counted at the end of the year, the inventory balance is updated. But if some inventory is not seen, in a warehouse closet, then inventory is misreported and there could be a subsequent misstatement.

Disclosure requirements



Material Weaknesses and Financial Reporting Quality

- Are Material Weaknesses Correlated with Restatements?
 - Internal control weaknesses predict restatements
- Why doesn't substantive testing fix this?
 - It does, sometimes. When the material weaknesses are account specific, they do NOT have more restatements (i.e., substantive testing works)
 - BUT when the problem is more general (e.g., segregation of duties, IT weaknesses), it is hard to know where to apply additional substantive testing. (Ge et al. 2007)

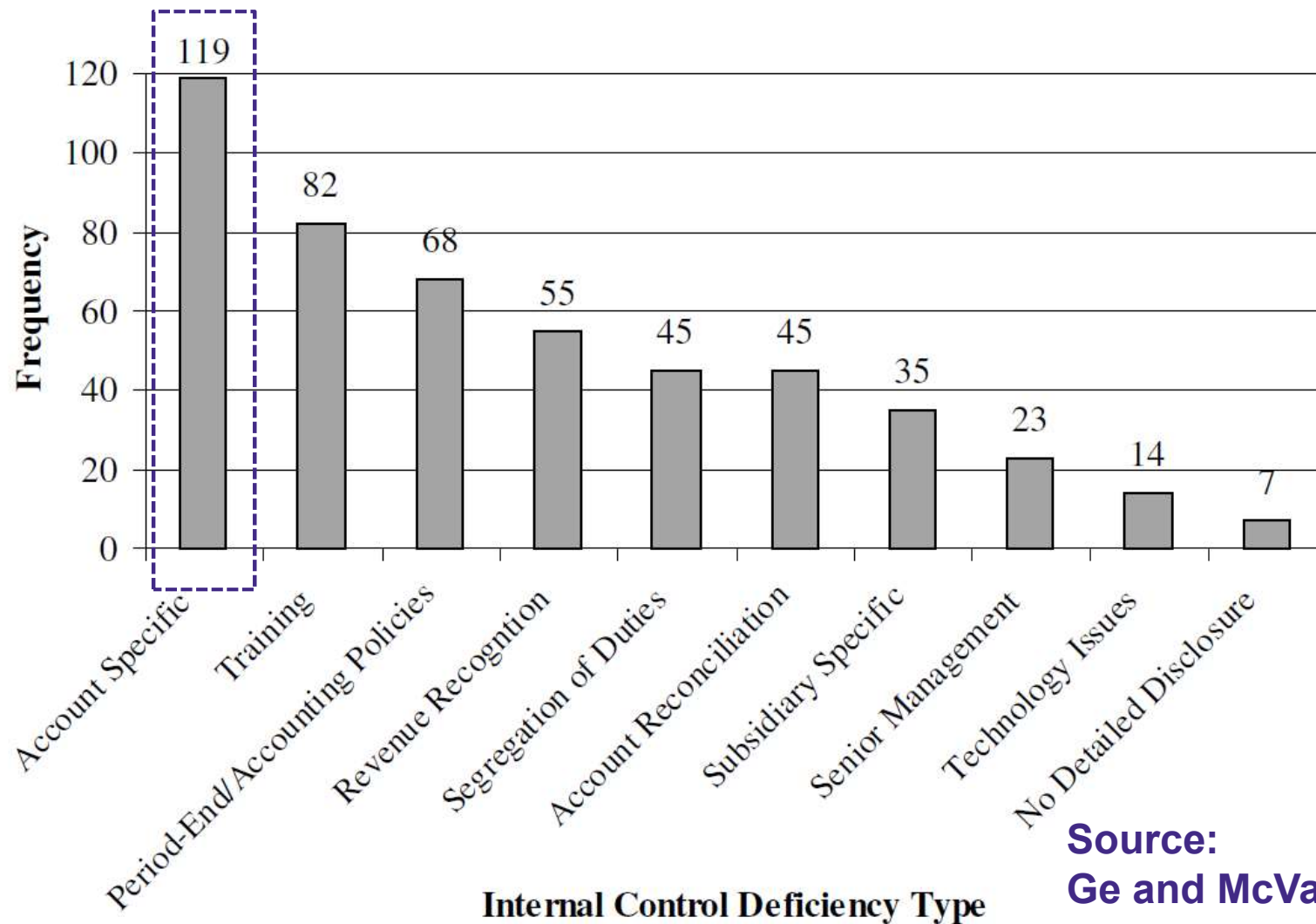
What firm characteristics might be related to weaknesses in internal control over financial reporting?

Early Post-SOX Evidence

Industry	Number of Material Weakness Firms within the Industry	Percentage of Material Weakness Firms within the Industry	Total Number of Firms within the Industry (Compustat 2003)	Percentage of Firms within the Industry (Compustat 2003)
Computers ←	51	21.4	853	13.7
Services	27	11.4	537	8.6
Banks and Insurance ←	22	9.2	1,377	22.1
Drugs and Medical Equipment	21	8.8	559	9.0
Miscellaneous Equipment	19	8.0	314	5.0
Retail	17	7.1	460	7.4
Rubber, Leather, and Metal	13	5.5	229	3.7
Transportation	13	5.5	333	5.3
Industrial Equipment	12	5.0	251	4.0
Refining and Extractive	9	3.8	196	3.1
Electrical Equipment	9	3.8	151	2.4
Mining and Construction	7	2.9	158	2.5
Utilities	7	2.9	287	4.6
Textiles, Printing, and Publishing	5	2.1	210	3.4
Food	3	1.3	112	1.8
Chemicals	3	1.3	135	2.2
Total	238	100.0	6,162	98.8 ^a

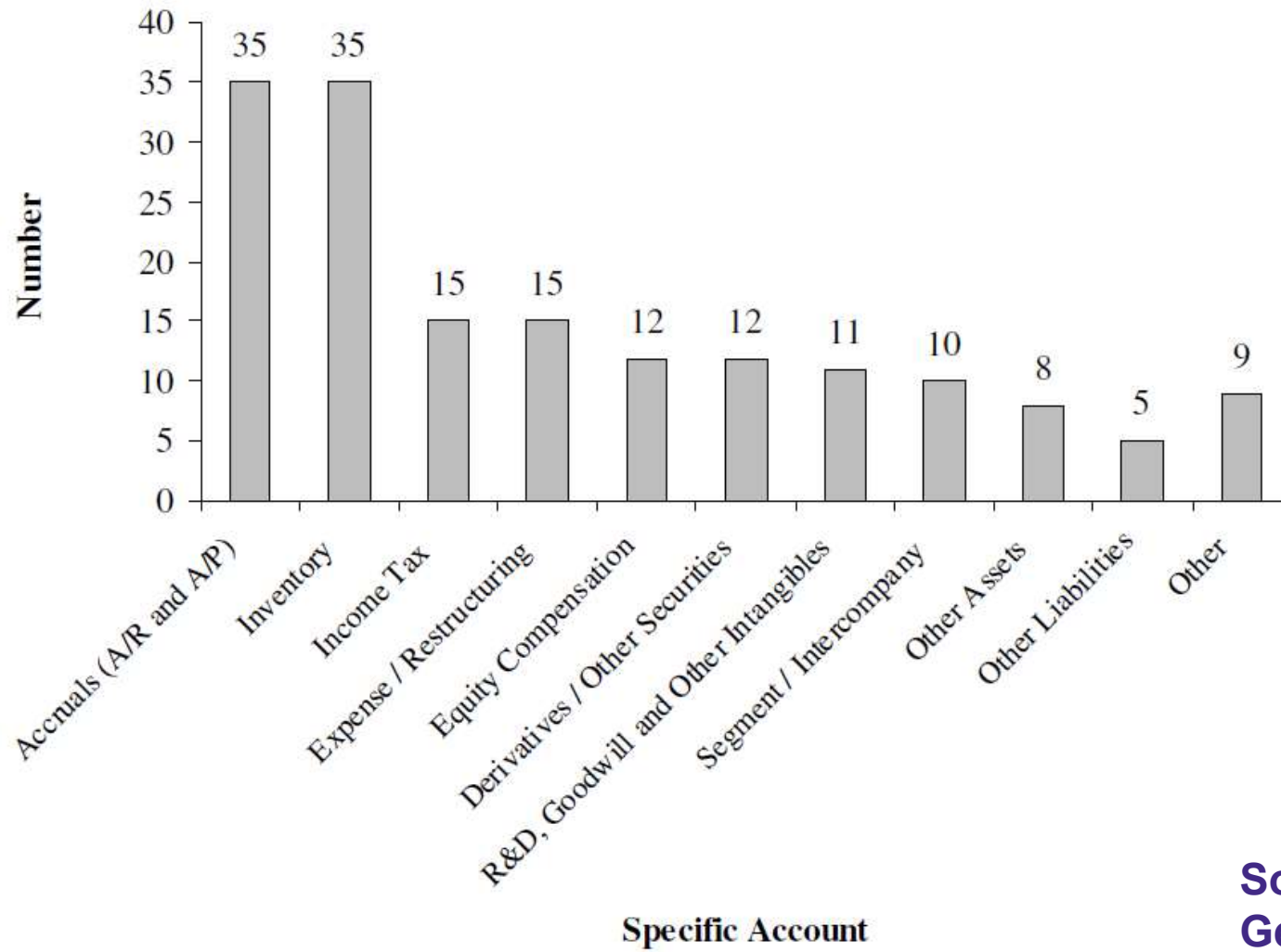
Source:
Ge and McVay (2005, AH)

FIGURE 2
Number of Material Weaknesses in Internal Control by Deficiency Type



Source:
Ge and McVay (2005, AH)

FIGURE 3
Number of Account-Specific Material Weaknesses by Account Type



Source:
Ge and McVay (2005, AH)

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Thank you!

