FOSTER
Master of Professional Accounting

AUDIT RISK AND MATERIALITY

Adv Cases in Assurance Services (ACCTG 521)

Class 3 | MPAcc class of 2026

Agenda

Review

Audit Risk and Planning

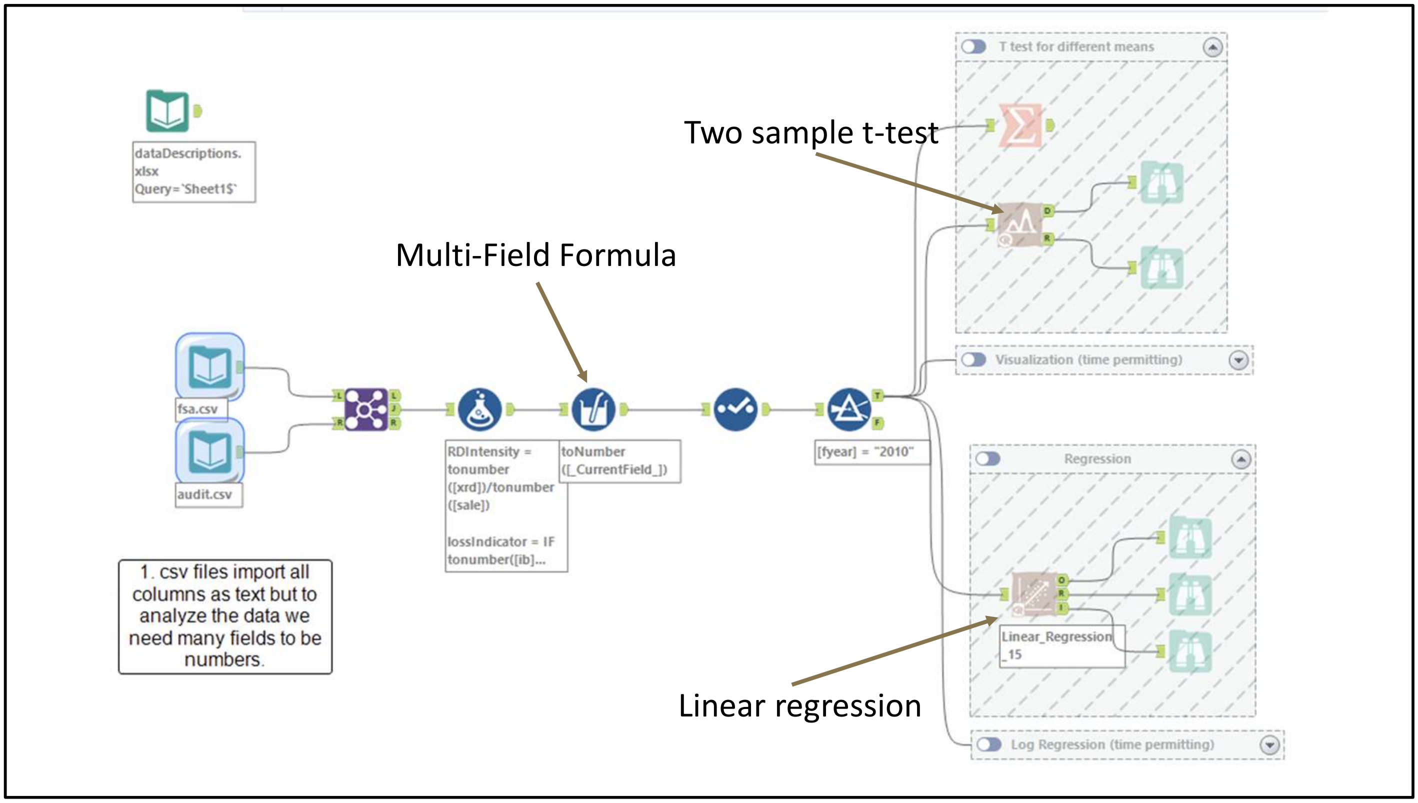
- Overview
- Qualitative Exercise: Identify Risks & Classify Accounts
- Materiality Discussion
- Semi-Quantitative / Qualitative Assessments of Materiality
- Dynamic Audit Planning Exercise

FOSTER
Master of
Professional Accounting

Review

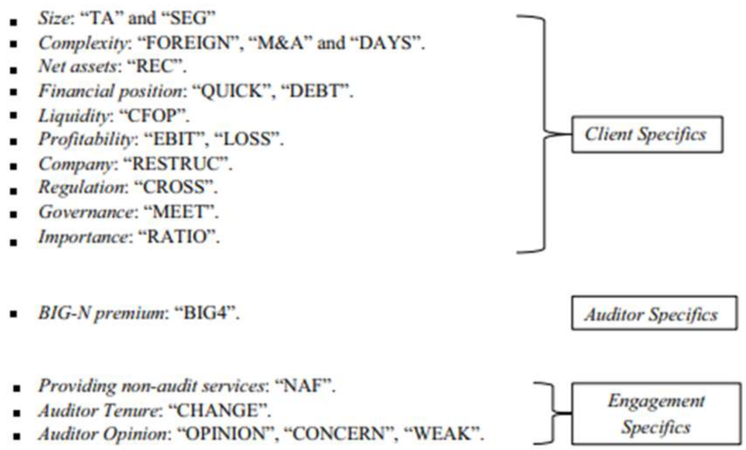
- Conflicting incentives for firms to disclose and withhold information
- Conflicting incentives for firms to undertake audits (or information verification)
- Factors that influence demand for audit and therefore audit fee include:
  - Agency conflicts
  - Information asymmetry
  - Risk of intentional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

FOSTER
Master of
Professional Accounting



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

Review – Evidence on the determinants of audit fees



Source: "What is it going to cost? Empirical evidence from a systematic literature review of audit fee determinants" Wiedmann et al. (2021) *Management Review Quarterly*

Table 3 Variable description

Variable	Category	Name	Description
TA	Size	Total assets	The logarithmic of total assets at the end of fiscal year
SEG	Size	Business Segments	The total number of business segments at the end of fiscal year
FOREIGN	Complexity	Foreign	Missing in paper, likely =1 if foreign subs are in 10-K exhibit 21.
M&A	Complexity	M&A	= 1, if client had a merger or acquisition in the audited period, 0 otherwise
DAYS	Complexity	Days	Total number of days between end of fiscal year and date of signing the audit opinion
REC	Net assets	Receivables	Ratio between total sum of receivables to total assets
QUICK	Financial position	Quick Ratio	Ratio between current assets to current liabilities
DEBT	Financial position	Debt	Ratio between total sum of debt to total assets
CFOP	Liquidity	Cashflow from operating activities	Ratio between cashflow from operating activities to total assets
EBIT	Profitability	EBIT	Ratio between EBIT and total assets
LOSS	Profitability	Loss	= 1, if client had a negative EBIT, 0 otherwise
RESTRUC	Company	Restructuring	= 1, if client reported any restructuring expenses, 0 otherwise
CROSS	Regulation	Cross-listed	= 1, if client is cross-listed at any other stock market, 0 otherwise
MEET	Governance	Board of Director Meetings	Number of board of director meetings within the audited period
RATIO	Importance	Ratio	Ratio of total sales of the client to all sales within the industry
BIG4	BIG-N premium	BIG-4	= 1, if auditor is a BIG-4 audit firm, 0 otherwise
NAF	Providing non-audit services	Non-audit fees	Logarithmic of total non-audit fees
CHANGE	Auditor Tenure	Change	= 1, if auditor changed in the period, 0 otherwise
OPINION	Auditor Opinion	Opinion	= 1, if auditor is not issuing an unqualified opinion, 0 otherwise
CONCERN	Auditor Opinion	Going concern issue	= 1, if auditor reports going concern issues, 0 otherwise
WEAK	Auditor Opinion	Internal control weakness	= 1, if auditor reports any intern al control weakness, 0 otherwise

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

FOSTER
Master of
Professional Accounting

Audit Risk and Planning: Overview

Team Assignments (reminder)

1	Duy Pham	5	Ross Aylward	9	Amanda Swetish
1	Jase Kobayakawa	5	Beau Anable	9	Chance Chittim
1	Lance Raymundo	5	Bobby Larson	9	Nathan Pettit
1	Anastasiya Alekseeva	5	Max Burke	9	Marta Eimer
2	Cade Farrington	6	Inga Damdin	9	Nathan Evans
2	Griffin Chadwick Knowles	6	Faye Izatt	10	Esther Han
2	Graham Allan Brower	6	Zach Kistner	10	Reece Campbell
2	Tricia Lu	6	Chloe Ibrahim	10	Maithili Patel
3	Elizabeth Nadrich	7	Karissa Geyer	10	Wanqi Dong
3	Garrett Packebush	7	Adriana Fachiol	10	Peter Yang
3	Annika Blumenstein	7	Sophia Carney		
3	Kelly Huang	7	Felicity Grimm		
4	Yanning Su	8	Ruiqing Cui		
4	Ryan Zhu	8	Trae Tingelstad		
4	Jinrong Zhang	8	Shay Sanchez		
4	William Jiang	8	Priscilla Hotzman		

Company Assignments for Today:

Team	Company	Headquarters
Team 1	Amazon.com, Inc. (Ticker: AMZN)	Seattle, WA
Team 2	Microsoft Corporation (Ticker: MSFT)	Redmond, WA
Team 3	Starbucks Corporation (Ticker: SBUX)	Seattle, WA
Team 4	Costco Wholesale Corporation (Ticker: COST)	Issaquah, WA
Team 5	Alaska Air Group, Inc. (Ticker: ALK)	Seattle, WA
Team 6	Expedia Group, Inc. (Ticker: EXPE)	Seattle, WA
Team 7	Nordstrom, Inc. (Ticker: JWN)	Seattle, WA
Team 8	Zillow Group, Inc. (Ticker: ZG)	Seattle, WA
Team 9	F5, Inc. (Ticker: FFIV)	Seattle, WA
Team 10	PACCAR Inc. (Ticker: PCAR)	Bellevue, WA

FOSTER
Master of
Professional Accounting

Audit Risk Model

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

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

- **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

FOSTER
Master of
Professional Accounting

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

12

FOSTER Master of Professional Accounting

Business Risk: Auditor's Perspective

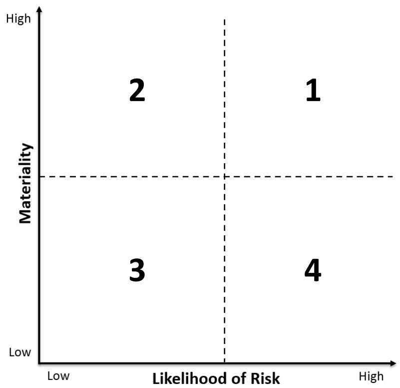
AS 2110 – during the planning phase of the engagement, auditors should obtain an understanding of the company and its environment, including:

- 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

FOSTER
Master of
Professional Accounting

Misstatement Risk

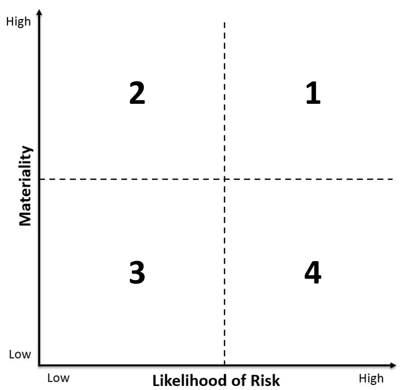
Function of Materiality and Probability



FOSTER
Master of Professional Accounting

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.

FOSTER
Master of
Professional Accounting

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

FOSTER
Master of
Professional Accounting

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

FOSTER Master of Professional Accounting

Required Risk Disclosures

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

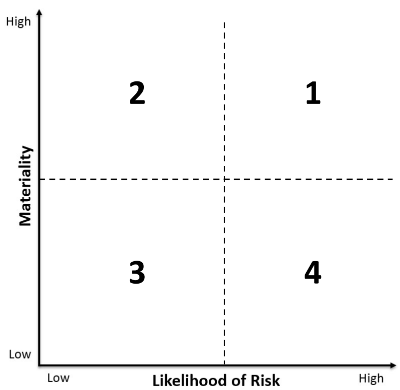
- Nature of estimates/assumptions is material due to levels of **subjectivity**, **judgment**, and **uncertainty**
- The impact of the estimates and assumptions is **material**

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

FOSTER
Master of
Professional Accounting

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.

FOSTER
Master of
Professional Accounting

Agenda

Review

Audit Risk and Planning

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

FOSTER
Master of
Professional Accounting

Materiality

FOSTER
Master of
Professional Accounting

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."

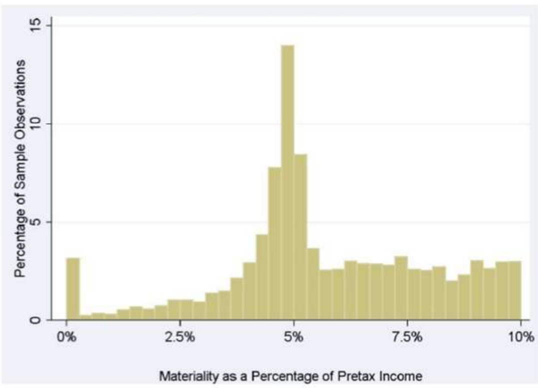
i.e., ***Influences the economic decisions of users***

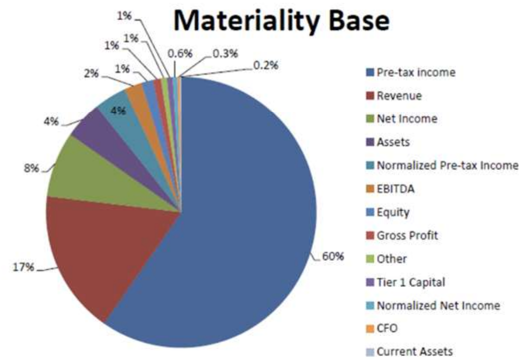
How do we translate this to numbers?

FOSTER
Master of
Professional Accounting

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





FOSTER
Master of
Professional Accounting

Agenda

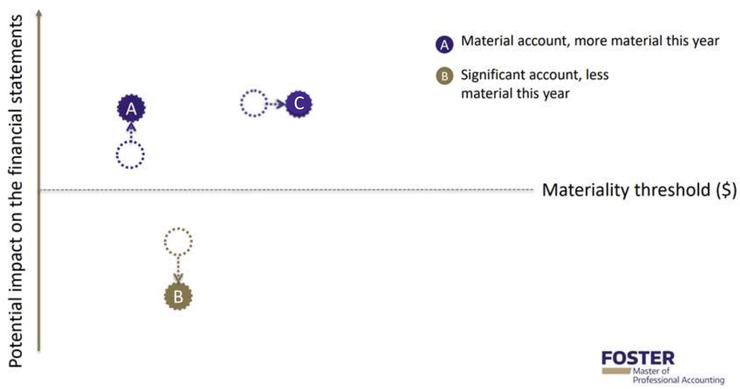
Review

Audit Risk and Planning

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

FOSTER Master of Professional Accounting

Group Exercise – part 2



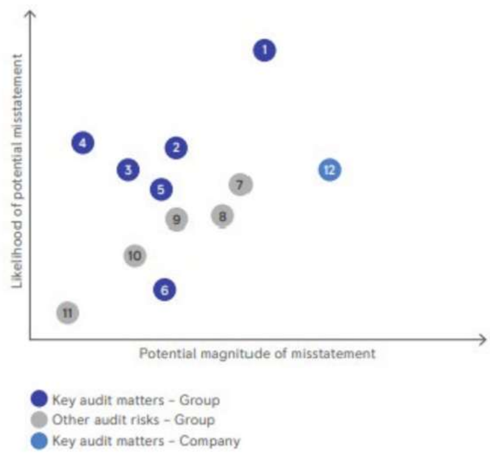
1. Remind the class of your company.

2. Identify **1 to 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.

3. Present your number 1 increased risk account and **why**

FOSTER Master of Professional Accounting

Dynamic Audit Planning - Viz



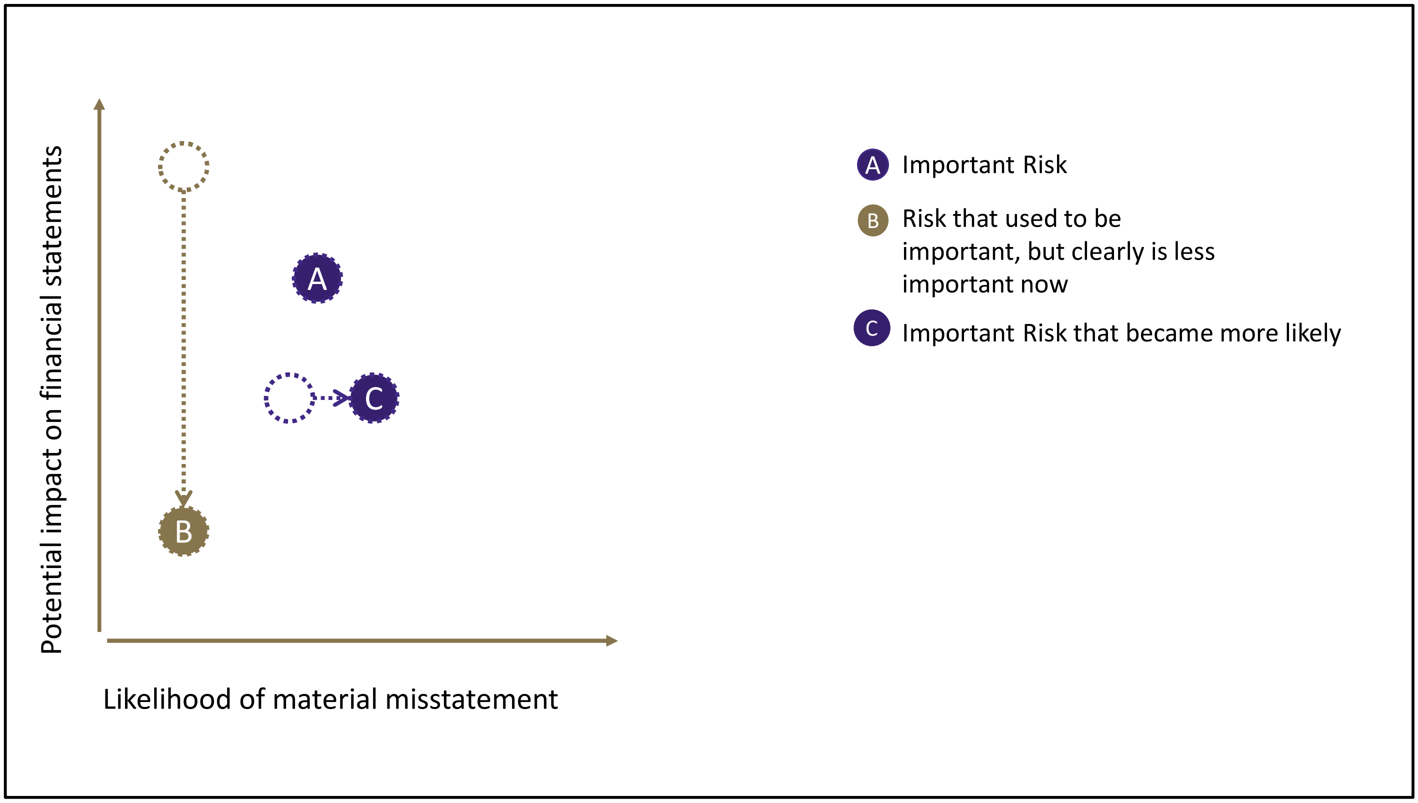
	Risks	Change from prior year
Key audit matters – Group		
1	Long-term contract accounting and associated provisions	<>
2	The recognition of deferred tax assets	<>
3	Presentation of underlying results and disclosure of other one-off items (including exceptional items)	<>
4	Translation of foreign currency 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

FOSTER
Master of
Professional Accounting

You can use any tool, either powerpoint (see next slide)
or something like LuidChart (free – login with Google, link below)

[Lucid Chart Audit Planning Template]

FOSTER
Master of
Professional Accounting


Potential impact on financial statements
Likelihood of material misstatement
A
B
C
A Important Risk
B Risk that used to be important, but clearly is less important now
C Important Risk that became more likely

THANK YOU

FOSTER
Master of
Professional Accounting