MODULE 4

Topic 2 – Substantive testing

In this Topic

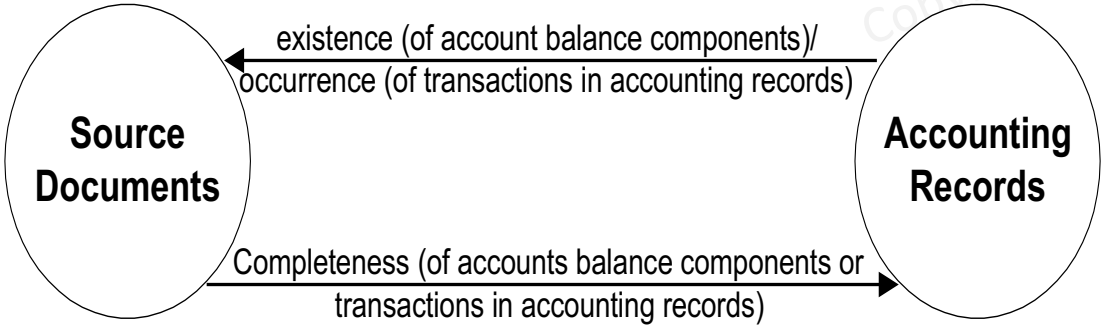
1. When and why do we need to gather substantive evidence
2. Types of substantive procedures
3. Designing substantive audit procedures
4. Sampling and substantive testing
5. Executing substantive tests
6. Evaluating substantive testing results and making conclusions

Context

2.1 When and why do we gather substantive evidence

Inside our client

- Supporting documentation & accounting records



When do we gather substantive evidence?

- Where there is a ROMM
- Where there is a specific control weakness
- Where there is greater inherent risk

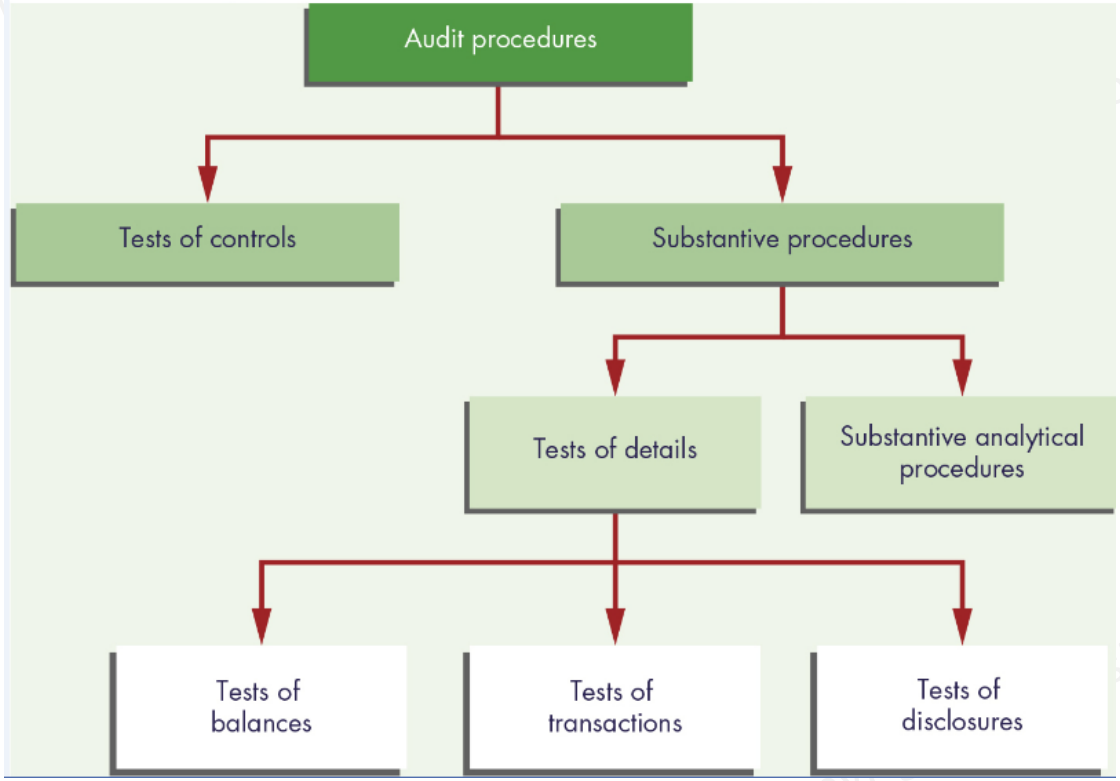
- Typically collected after we've tested internal controls

2.2 Types of substantive audit procedures

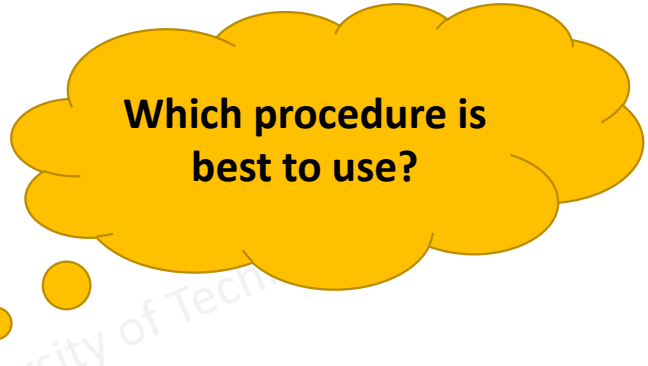
Controls vs. Substantive Testing

- Controls testing aims to obtain evidence that entity's controls operate effectively (E.g. the transaction was appropriately authorised before being processed)
- Substantive tests are procedures performed on specific transactions and balances to test for dollar misstatements in an account balance or transaction.
- The main difference between these tests is that controls testing does not directly measure dollar ($) error in the accounting records.
    - When an auditor tests if a document has been appropriately authorised = Test of Control.
    - When an auditor tests if a dollar amount is correct = Substantive Test.

Types of Audit Procedures



Types of Substantive Tests



- There are three types of Substantive tests:
  - Substantive Tests of Transactions: Where an auditor focuses on testing individual transactions by verifying them to supporting documentation.
  - Substantive Tests of Balances: Where an auditor focuses on substantiating the ending balance of an account (which is comprised of multiple transactions)
    E.g. through external confirmations.
  - Analytical Procedures: Use of comparisons and relationships to assess whether account balances appear reasonable.
    Note: Analytical Procedures is the most basic type of substantive test.

Substantive Tests and Assertions

- The auditor must perform audit procedures and collect sufficient appropriate evidence for each account and assertion.

- But for each of the major account balances or classes of transactions, there are different assertions at higher risk of misstatement and therefore the substantive audit procedures used to test them are also different.

- NOTE: Procedures must LINK to the assertions being tested in both controls and substantive testing.

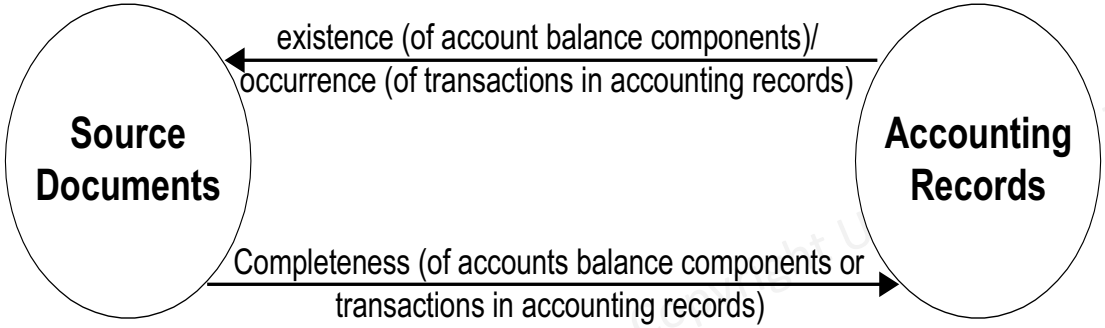
2.3 Designing substantive audit procedures

Reminder of the list of procedures

1. Inspection
2. Observation
3. External confirmation
4. Recalculation
5. Reperformance
6. Analytical procedures
7. Enquiry
8. Vouching
9. Tracing

Substantive Tests and Assertions

- The direction of testing relates to the assertion tested.
  - Individual transactions can be traced forward through each step of the accounts to their inclusion in the financial report (assertion of completeness); or
  - From the financial report the transactions can be vouched back to the original supporting documents (relates to existence or occurrence).



How do we decide what procedure to use?

- What assertion are we testing?
- Nature timing and extent of audit procedures
  - Nature
  - Timing
  - Extent

2.3.1 Examples of substantive procedures - sales

- What assertions are at higher ROMM?

Occurrence	
Completeness	
Accuracy	
Cutoff	
Classification	
Presentation	

2.3.2 Examples of substantive procedures – accounts receivable

- What assertions are at higher ROMM?

Existence	
Completeness	
Accuracy, Valuation and Allocation	
Rights and obligations	
Presentation	

2.3.3 Examples of substantive procedures – cash

- What assertions are at higher ROMM?

Existence	
Completeness	
Accuracy, Valuation and Allocation	
Rights and obligations	
Presentation	

2.4 Sampling and substantive testing

Do we even need to sample?

Sampling for different Audit Tests

Type of test	Where to sample
Tests of Controls	Controls operating over the entire year
Tests of Details of Balances	End of year balances and sub-account balances at year-end (e.g. Accounts Receivable per customer)
Tests of Transactions	Transactions over the entire year
Analytical Procedures	No Sampling involved

Which Sampling method should be used?

	Sampling method
Most commonly used method	
Most appropriate for testing across the entire year	
Most appropriate for testing the assertion of Cut-off	
When you want to treat/investigate sub-groups differently – what do you do?	

Sampling and Stratification

- Stratified Sampling:
  Stratification is the process of dividing the population into a series of sub-populations which are then treated separately in terms of sampling methods and testing.

- For example:
  Auditing Accounts Receivable – stratified by days the receivables have been overdue:

0-30 days	31-60 days	61-90 days	91+ days	Total
$350,000	$300,00	$200,000	$150,000	**$1,000,000**

- Note: Stratification is not a sampling method - it is simply the process of dividing the population.

Factors Influencing Sample Size for Substantive Tests

ASA 530 – Appendix 3

Factor	Effect on sample size
1. An increase in the auditor's assessment of the risk of material misstatement	**Increase**
2. An increase in the use of other substantive procedures directed at the same assertion	**Decrease**
3. An increase in the auditor's desired level of assurance	**Increase**
4. An increase in the tolerable misstatement	**Decrease**
5. An increase in the amount of misstatement the auditor expects to find in the population	**Increase**
6. Stratification of the population when appropriate	**Decrease**
7. An increase in the number of sampling units in the population	**Negligible effect**

2.5 Executing substantive tests

We will cover this in our workshop in a follow-along activity

2.6 Evaluating substantive testing and making conclusions

Audit evidence – it helps us ask more questions!

Nature and Cause of Deviations and Misstatements

12. The auditor shall investigate the nature and cause of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit. (Ref: Para. A17)

13. In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population. The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

Is the misstatement material?

Projecting Misstatements

14. For tests of details, the auditor shall project misstatements found in the sample to the population. (Ref: Para. A18-A20)

Evaluating Results of Audit Sampling

15. The auditor shall evaluate:

    (a) The results of the sample; and (Ref: Para. A21-A22)

    (b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested. (Ref: Para. A23)

Evaluation of Substantive Testing

Substantive Testing
Misstatement/Error: Any situation where the amount is incorrect (i.e. the audited amount differs from that recorded in the client's records)
Set **Tolerable level of Misstatement:** Amount of misstatement that the auditors are willing to tolerate or accept - does this sound familiar?
Conduct the substantive tests of transactions and/or balances according to the procedures designed and identify any misstatements
Calculate PROJECTED Misstatement = Misstatement Amount / Total Value of Sample x Value of Population
Evaluation: Investigate the source of the misstatements – one-off or systematic issue? Collect another sample and re-perform the test? Is the issue still present? If **Projected Misstatement > Tolerable Amount** = **Material Misstatement** Advise management to make the required adjustments, otherwise = **Modified Report**

Basic Example of Projected Misstatement

- Misstatements found in the sample: $250,000
- Value of the sample: $2,000,000
- Value of the population $5,000,000

- Calculate the Projected value of misstatements over the entire population

  =

- Is this material? What information do you need to make this decision?

A more complex example - stratification

- Auditing Accounts Receivable - stratified by days overdue

	0-30 days	31-60 days	61+ days
Errors Found	$2,000	$4,500	$3,000
Value of Sample	$100,000	$85,000	$100,000
Value of Population	$850,000	$450,000	$100,000
Projected misstatement	$	$	$

- Total misstatement for Accounts Receivable:_____

To sum up

- Use your knowledge of the client – inherent risks, significant risks, control risks – to determine what assertions are at greatest risk and you need to gather evidence on.
- Remember how to apply the 4 design rules