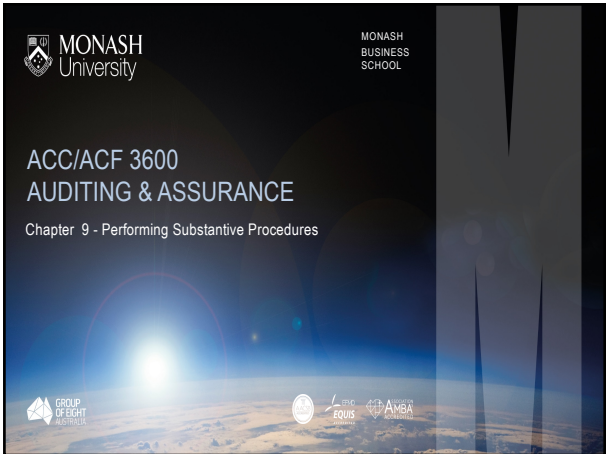




1

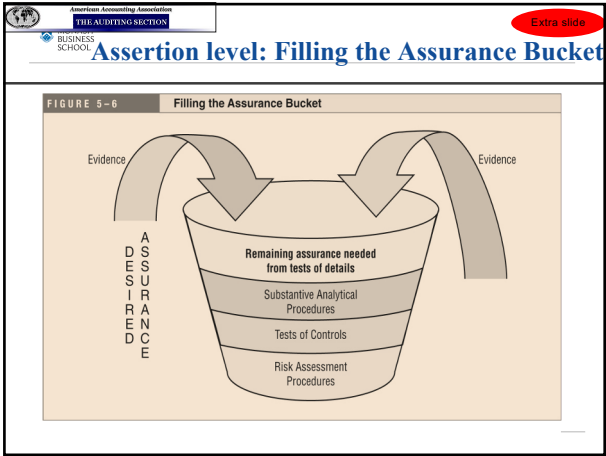
LEARNING OBJECTIVES

AFTER STUDYING THIS CHAPTER YOU SHOULD BE ABLE TO:

- 9.1 describe **substantive audit procedures**
- 9.2 explain the link between the **audit risk model** and the **nature, timing** and **extent** of substantive procedures
- 9.3 produce examples of **different substantive audit procedures**
- 9.4 discriminate between the **various levels of audit evidence** obtained when performing substantive procedures
- 9.5 explain the **documentation of the conclusions** reached as a result of performing substantive procedures.

Adapted from Monahan, Robyn, et al. (2017), *Auditing: A practical approach* (3rd ed.), Wiley

2



3

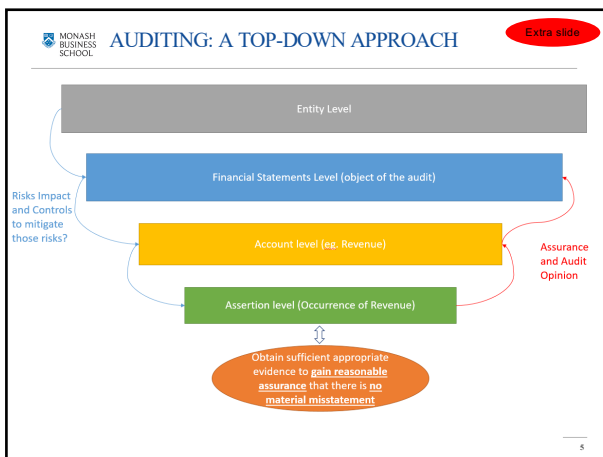
MONASH BUSINESS SCHOOL

OVERVIEW OF SUBSTANTIVE PROCEDURES (Figure 9.2)

CONTROL RISK ASSESSMENT				
		LOW	MEDIUM	HIGH
		Controls tested extensively and able to be relied upon	Limited controls tested and able to be relied upon	No controls tested and no assurance from controls
INHERENT RISK LOW	Lower risk of material errors if no controls in place	Few substantive procedures required	Some substantive procedures required	Considerable substantive procedures required
INHERENT RISK HIGH	Higher risk of material errors if no controls in place	Some substantive procedures required	Considerable substantive procedures required	Extensive substantive procedures required

Adapted from Mooney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley

4



5

- MONASH BUSINESS SCHOOL
- OVERVIEW OF SUBSTANTIVE PROCEDURES
- Risk assessments must be performed at assertion level (ASA 315; ISA 315)**
- **Assertions can be stated as audit objectives**
 - Management assert that sales transactions recorded in income statement **occurred** and **relate** to the entity
 - Auditor's **objective** is to verify that recorded sales transactions **occurred** and **relate** to the entity (**occurrence and rights and obligations**)
 - **Transaction assertions are related to account balance and disclosure assertions**
 - Work done to verify **sales occurrence** provides some evidence about **accounts receivable existence**
- Adapted from Mooney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley

6

OVERVIEW OF SUBSTANTIVE PROCEDURES

Assertions about transactions and events	Assertions about account balances at year-end	Assertions about presentations and disclosure
Typically income statement accounts	Typically balance sheet accounts	Disclosures made in the financial report
Occurrence	Existence Rights and obligations	Occurrence Rights and obligations
Completeness Cut off	Completeness	Completeness
Accuracy	Valuation and allocation	Accuracy and valuation
Classification		Classification and understandability

Adapted from Mooney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

7

7

DEFINITION OF SUBSTANTIVE PROCEDURES

SUBSTANTIVE PROCEDURES:

- Audit procedures that are designed to **detect material misstatements at the assertion level**
- They are used to obtain **direct evidence** as to the completeness, accuracy, and validity of data, and the reasonableness of the estimates and other information contained in the financial report
- **Audit program documents substantive procedures** the auditor plans to use to identify and rectify material errors before giving the audit opinion

Adapted from Mooney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

8

8

DEFINITION OF SUBSTANTIVE PROCEDURES

Nature, timing and extent of substantive procedures in audit program determined by:

- **Risk of material misstatement**
- **Timing considerations** affect nature of substantive test (e.g. access during interim periods)
- **Level of assurance necessary** (reasonable or limited)
- **Type of evidence required** (how persuasive)
- **Complexity** of client's data systems

Adapted from Mooney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

9

9



RELATIONSHIP BETWEEN RISK ASSESSMENT AND THE NATURE, TIMING AND EXTENT OF SUBSTANTIVE PROCEDURES

The nature of substantive testing **varies from account to account** and consists of **one or a combination** of techniques, including:

- Key items testing
- Representative testing
- Other test of transactions/underlying data
- Analytical procedures

Adapted from Mooney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.), Wiley

10

10



RELATIONSHIP BETWEEN RISK ASSESSMENT AND THE NATURE, TIMING AND EXTENT OF SUBSTANTIVE PROCEDURES

The appropriate mix of substantive procedures depends on:

- The **nature** of the **account balance**
- The **risk assessment** for the specific account and the client overall

Adapted from Mooney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.), Wiley

11

11



TIMING OF SUBSTANTIVE PROCEDURES

• Influenced by **level of control risk**

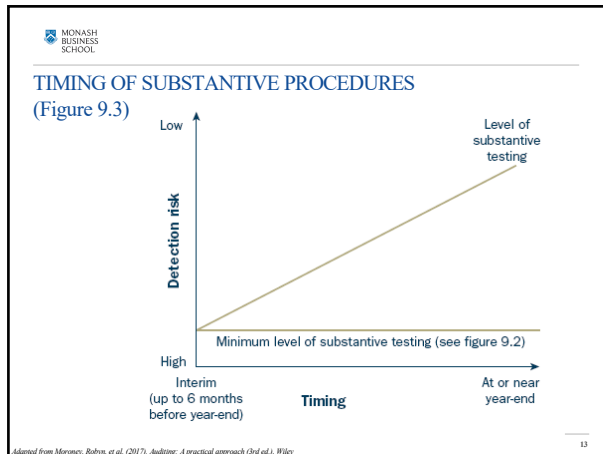
• Typically at or near year-end, exceptions include:

- Accounts that **accumulate transactions** that mostly remain in year-end balance
- For example, additions to fixed asset register
- Control testing confirms **a strong control system**
- **Roll-forward procedures** are suitable due to strong controls and **no changes** to controls
- Roll-forward procedures are done between interim date and year-end, and provide evidence that interim testing results continue to apply for the remainder of the period

Adapted from Mooney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.), Wiley

12

12



13

MONASH BUSINESS SCHOOL

SUBSTANTIVE AUDIT PROCEDURES

TESTS OF DETAILS:

- Substantive tests **other than analytical procedures**
- Designed to **verify a balance or transaction with supporting documentation**
 - **Vouching**: taking a balance or transaction **from the underlying accounting records** and verifying it by agreeing the details to **supporting evidence** outside of the accounting records of the company
 - ❖ Primarily tests **existence/occurrence** assertion
 - **Tracing**: tracking a **source document to the accounting records**
 - ❖ Primarily tests **completeness** assertion

Adapted from Mooney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

14

MONASH BUSINESS SCHOOL

SUBSTANTIVE AUDIT PROCEDURES

1. KEY ITEM TESTING

- Identify **key items** in a balance
- Usually select **largest transactions** within a balance to obtain 'coverage' of the total
- The **more persuasive other evidence available**, the **less coverage key items** have to address

2. REPRESENTATIVE SAMPLING

- If further testing required after selecting key items
- Select items that are **representative of population**
- Sampling strategy depends on **auditor's expectations of error** and **overall audit objective** (i.e. testing primarily for over or understatement of balance)

Adapted from Mooney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

15

MONASH BUSINESS SCHOOL

SUBSTANTIVE AUDIT PROCEDURES

3. OTHER TESTS OF TRANSACTIONS/ UNDERLYING DATA:

- Tests of **client prepared schedules**
- Tests performed at interim date with **roll-forward procedures**
- Tests of **underlying data** to be used as **part of analytical procedures**
- Tests of income statement accounts for **account classification**
- Tests of **individual transactions** by vouching (agreeing) to supporting documents

Adapted from Mooney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley

16

16

MONASH BUSINESS SCHOOL

SUBSTANTIVE AUDIT PROCEDURES

4. ANALYTICAL PROCEDURES can be used as:

- **Primary (persuasive) tests** of a balance
- **Corroborative tests** in combination with other procedures
- To provide at least some **minimal level of support** for the conclusion
- Analytical procedures can be the most effective test of a balance, or at least **reduce extent of other substantive tests** (ASA 520; ISA 520)

Adapted from Mooney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley

17

17

MONASH BUSINESS SCHOOL

SUBSTANTIVE AUDIT PROCEDURES

TYPES OF ANALYTICAL PROCEDURES:

- **Absolute data comparisons** (prior year, budgets)
- **Ratio analysis** (activity, liquidity, profitability, leverage)
- **Trend analysis** (over several accounting periods)
- **Common-size** financial reports
- **Break-even analysis**
- **Pattern analysis and regression** (most sophisticated)

Adapted from Mooney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley

18

18

MONASH BUSINESS SCHOOL

SUBSTANTIVE AUDIT PROCEDURES

TESTING THE RELIABILITY OF ANALYTICAL PROCEDURES:

- Mitigate risk of accepting account as not misstated when it is materially misstated
- Consider **relevance** of analytical procedures, they are **less useful** when:
 - client's operations are **diverse**
 - industry data is **unreliable** or **not comparable** to client
 - **severe inflation**
 - client's **budget process not well-controlled**
- Consider **reliability** of data
 - For example, test reliability of ageing of debtors reports
 - Do **control tests** suggest data is reliable?
 - Consider **controls over non-financial data**

Adapted from Mooney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley

19

MONASH BUSINESS SCHOOL

SUBSTANTIVE AUDIT PROCEDURES

SUMMARY OF ANALYTICAL PROCEDURES APPROACH:

1. **Identify computation, comparison**, to be made
2. **Assess reliability** of any data to be used
3. **Estimate** probable balance or outcome
4. **Perform computations** using internal or external data
5. **Compare** estimated amount with calculation, **assess if any difference is significant**
6. **Determine appropriate procedures** for investigating **reasons for the difference**
7. **Perform procedures**
8. **Draw conclusions**

Adapted from Mooney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley

20

MONASH BUSINESS SCHOOL

SUBSTANTIVE AUDIT PROCEDURES

USING COMPUTERS FOR SUBSTANTIVE TESTING:

- **Computer assisted audit techniques (CAATs)** assist auditors with their testing in complex tasks. There are two main categories.
 1. Software used to **interrogate** and **examine client files** (software can be special programs or spreadsheets)
 - Re-adding, performing logic tests, select key items, representative samples
 - Handle large volumes of data, be more comprehensive
 2. Software that **individual firms use to plan, perform and evaluate audit procedures**, regardless of whether client automated or not
- **CAATs are more useful when client controls are stronger**

Adapted from Mooney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley

21

LEVELS OF EVIDENCE

Evidence from different types of substantive procedures varies in persuasiveness

1. PERSUASIVE EVIDENCE

- Is suitable as **primary test** of balance
- Provides a **reasonable estimate** of balance, enabling auditor to **conclude** whether or not the account balance is free from material errors
- **No further procedures required**

Adapted from Mooney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

22

22

Examples of analytical procedures that provide persuasive evidence (Table 9.2)

EVIDENCE	ANALYTICAL PROCEDURE
Material content of work in progress and finished goods	Relate raw materials put into productions an quantities sold to normal yield factors
Overheads in closing stock	Relate actual overheads for the period to actual direct labour, production volumes or another appropriate measure
Finished goods stock pricing	Refer to selling prices less selling costs and 'normal' gross margin
Charges for depreciation	Refer to asset balance, effect of additions and disposals and average depreciation rate
Payroll expenses	Refer to days accrued and average daily payroll or subsequent period's gross payroll
Commission expense	Refer to commission rates and related sales
Accruals for commissions or royalties	Refer to terms of agreements and payments dates
Accrued warranty costs for established products	Refer to applicable payroll and previous year's contribution rate
Scrap income	Relate standard cost scrap factor to weight of material process and apply the result to published scrap prices
Interest expense and related accrual	Refer to the average debt outstanding, weighted average interest rate and payment dates
Investment income	Relate average amounts invested to an average interest rate or yield
Total revenue for a school	Relate school fee per each year level by the number of students in each respective level

Adapted from Mooney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

23

23

LEVELS OF EVIDENCE

2. CORROBORATIVE

- Confirms **audit findings** from other procedures
- Supports management representations
- Allows auditor to **limit extent of other procedures** in the area
- **Unexpected results** would require auditor to **expand other substantive audit procedures** to provide explanation of result
- **Professional scepticism** – important to search for **confirming and disconfirming evidence**

Adapted from Mooney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

24

24

Examples of analytical procedures that provide corroborative evidence (Table 9.3)

EVIDENCE	ANALYTICAL PROCEDURE
Cash balances	Compare the listing of cash accounts with those of prior periods and investigate any unexpected changes (e.g. credit balances, unusual large balances, new accounts, closed accounts) or the absence of expected changes .
Trade receivables, sales, going concern	Review the volatility of the customer base (e.g. new customers as a percentage of existing customers) and compare with expectations.
Trade receivables	Compare the current period's receivables as a percentage of net sales with prior periods' percentages, and consider the reasonableness of the current periods' percentage in relation to current economic conditions, credit policies and collectability.
Prepayments	Compare the prepayment account balances with those of prior periods and investigate any unexpected changes (or the absence of expected changes).
Property, plant and equipment	Review the reasonableness of the provision for depreciation by reference to prior-year provision and the effects of acquisitions and disposals.
Sales, commissions expense	Compare sales commissions or bonuses with related sales.
Payroll expense	Compare payroll tax expenses to the annual payroll time the statutory tax rates.

Adapted from Mooney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

25

25

LEVELS OF EVIDENCE

3. MINIMAL

- **Not persuasive or corroborative**
- For example, simple comparison with previous year to **help identify problems**, not to reduce other testing
- Usefulness of procedure to generate more persuasive evidence depends on circumstances such as **complexity of client** and **extent of fluctuations** in particular account balance

Adapted from Mooney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

26

26

Examples of analytical procedures that provide minimal evidence (Table 9.4)

EVIDENCE	ANALYTICAL PROCEDURE
Cash balances	Review the cash accounts in the general ledger for unusual items
Trade receivables	Understand the reason for any large credit transactions/balances on the ledger
Trade receivables	Compare the number and amounts of credit notes issued with those of prior periods
Trade Payables	Compare the number of days purchases in trade payables with prior periods
Property, plant and equipment	Review the property, plant and equipment and related accounts in the general ledger for unusual items
Equity	Compare the equity account balance with that of prior years and investigate any unexpected changes (or the absence of expected changes)
Payroll expense, cost of sales	Compare the relationship between direct labour costs and number of employees with prior periods.

Adapted from Mooney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

27

27



EVALUATING, DOCUMENTING RESULTS

- Auditor's **understanding of the client's business** helps **identify likely fluctuations** in financial data
 - For example, **Seasonal trends**, **dependent relationships**, **specific business decisions**
- **Expectations of likely fluctuations** helps the auditor to **interpret results**
 - **Absence of fluctuation** could be more suspicious than a **large fluctuation**

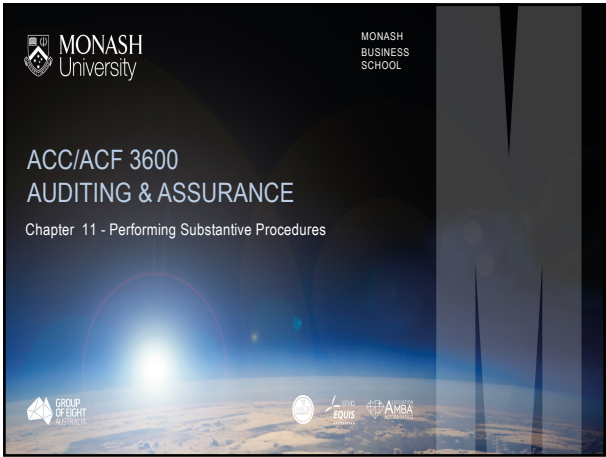
28



MONASH
BUSINESS
SCHOOL

ACC/ACF 3600
AUDITING & ASSURANCE

Chapter 11 - Performing Substantive Procedures





29



LEARNING OBJECTIVES

After studying this chapter you should be able to:

- 11.1 Explain the relationship between the **overall risk assessment** for a significant account and the **extent** and **timing** of substantive procedures, and the differences between auditing **income statement** and **balance sheet accounts**
- 11.2 Design and explain how to execute substantive procedures to address audit risk related to **revenue**
- 11.3 Design and explain how to execute substantive procedures to address audit risk related to **cost of sales and other significant expenses**
- 11.4 Explain how to **assess the results** of the substantive procedures to determine whether additional substantive tests are necessary.

30

10

RISK AND SUBSTANTIVE PROCEDURES

Differences between auditing income statement and balance sheet accounts:

- Balance sheet accounts typically represent only recent transactions, or one-off transactions
- Income statement accounts reflect sum of entire reporting period transactions
- Testing balance sheet accounts do not provide much assurance about income statement accounts
- Difference in nature of account is reflected in difference in testing
- Typically use analytical procedures for income statement accounts rather than confirmations etc.

Adapted from Mooney, Rubin, et al. (2017), Auditing: A practical approach (3rd ed.), Wiley.

31

31

RISK AND SUBSTANTIVE PROCEDURES

• Extent of substantive procedures

- As discussed for balance sheet accounts, extent of testing determined by risk assessment for each significant account or disclosure
- High IR, CR: do not rely on and test controls, use significant amount of substantive testing to reduce DR
- Low IR, CR: testing controls shows them to be effective, limited substantive testing required

• Timing of substantive procedures

- Dependent on risk assessment, can perform some types of work prior to year-end, leverage off internal audit etc.

Adapted from Mooney, Rubin, et al. (2017), Auditing: A practical approach (3rd ed.), Wiley.

32

32

SUBSTANTIVE TESTING - REVENUE

• SALES IS USUALLY A VERY SIGNIFICANT ACCOUNT

- Pressure to achieve sales targets creates risk of overstatement
 - ❖ High overall inherent risk, e.g. manipulation, fraud
- Also significant because generally:
 - ❖ Material size
 - ❖ High volume of transactions
- Auditors usually either use only substantive testing techniques, or use controls testing supplemented with high-level analytical procedures

Adapted from Mooney, Rubin, et al. (2017), Auditing: A practical approach (3rd ed.), Wiley.

33

33

SUBSTANTIVE TESTING – REVENUE

MOST IMPORTANT ASSERTIONS:

- **OCCURRENCE**
 - Test recorded sales are bona fide and have **occurred**
- **ACCURACY**
 - Sales are recorded at **correct amount, not overstated**
- **CUT-OFF**
 - Risk that sales occur **after year-end** are recorded early

Adapted from Mooney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley.

34

34

SUBSTANTIVE TESTING – REVENUE

- **COMPLETENESS** is not usually significant, except if pressure to increase **next year's sales**
- **Service revenue** requires testing **projects delivered** to customers, or **in progress**
- **Interest, dividend revenue** – recalculate, check bank statements
- Other items not usually material

Adapted from Mooney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley.

35

35

SUBSTANTIVE TESTING – REVENUE (Table 11.1)

OBJECTIVE	ASSERTION
All sales included in the income statement represent the exchange of goods or services with customers for cash or other consideration during the period. All other revenues included in the income statement for the period have accrued to the entity at year-end. Revenues applicable for future periods have been deferred.	OCCURRENCE (O)
All sales and other revenues that accrued to the entity during the period are included in the income statement.	COMPLETENESS (C)
Sales and other revenues are stated in the income statement at the appropriate amounts and in the appropriate period .	ACCURACY, CUT-OFF
Sales and other revenues are properly classified, described and disclosed in the financial report including in the notes.	CLASSIFICATION (CI) CLASSIFICATION AND UNDERSTANDABILITY (C&U)

Adapted from Mooney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley.

36

36

SUBSTANTIVE TESTING – REVENUE

PROCESSES IMPACTING SALES REVENUE:

- Sales and sales returns and allowances
- Consider evidence from interim testing, control testing phase
- If substantive testing required, use detailed testing such as vouching, tracing of documents, recalculating pricing and discounts, testing postings

Adapted from Monney, Rubin, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley.

37

37

SUBSTANTIVE TESTING – REVENUE (Table 11.2)

SALES PROCESS	SALES RETURNS AND ALLOWANCES (CREDIT MEMOS) PROCESS
Perform a proof of cash by reconciling the activity per the client records to activity per the bank. Correlate activity with the recorded sales for the year and the change in trade receivables balance. (Effectiveness of procedures is limited to less complex engagements.) (O, A)	Compare credit memos and supporting documents with the sales returns and allowances ledger as to dates, customers, products, quantities, prices and amounts. (C)
Test the records of products ordered and shipped to the sales records. Agree dates, customers, products, quantities, prices and amounts. (C, A)	Account for the numerical sequence of credit memos during a specified period. (C)
Test the posting of individual sales invoices to the sales ledger and to the trade receivables sub-ledger. (C)	Test the posting of individual credit memos to the sales returns and allowances ledger and to the trade receivables sub-ledger. (C, A)
Account for the numerical sequence of sales invoices, sales orders and shipping documents during a specific period. (C)	Compare credit memos with the documents supporting returns and allowances as to dates, customers, products, quantities, prices and amounts. (C, A)
Test recorded sales to the records of products shipped. Agree dates, customers, products, quantities, prices and amounts. (O, A)	Test the authorisation of credits, discounts and allowances. (A)

Adapted from Monney, Rubin, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley.

38

38

SUBSTANTIVE TESTING – REVENUE (Table 11.3)

EXAMPLE TESTS ALWAYS PERFORMED

Compare the monthly income statements to budget and/or prior year and investigate any unexpected fluctuations or absence of expected fluctuations. (C, A, CI)

EXAMPLE ANALYTICAL PROCEDURES

General

Review the client's comparison of budgeted and actual revenues by month or by quarter. Corroborate some of the reasons identified by the client for important variations. Investigate any unexpected variations or the absence of expected variations that were not identified by the client.

(C, A, CI)

Sales

Compare sales to the current year's budget and to the prior period's actual sales by product line or geographic area. (C, A, CI)

Other Revenue

Obtain detailed analysis of selected revenue accounts and trace the details to the source data. (CI)

EXAMPLE OTHER GENERAL PROCEDURES

Sales

Enquire about management, sales personnel or other parties who may be receiving products without billing or payment. (O, A)

Other Revenue

Obtain detailed analysis of selected revenue accounts and trace the details to the source data. (CI)

Adapted from Monney, Rubin, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley.

39

39

SUBSTANTIVE TESTING – COST OF SALES AND EXPENSES

COST OF SALES AND EXPENSES ARE SIGNIFICANT ACCOUNTS IN INCOME STATEMENT

- Major risk relates to **understatement**
- Key assertions are **accuracy**, **completeness** and **cut-off**

Adapted from Maroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley.

40

40

SUBSTANTIVE TESTING – COST OF SALES, EXPENSES

ACCURACY

- Verify by vouching **recorded amounts** to **documents** or **underlying account**, e.g.
 - **Depreciation** – tested as part of verifying **PPE balance**
 - **Bad debts** – part of verifying **receivables balance**
 - **Cost of sales** is verified to:
 - ❖ **Opening stock balance** (last year closing balance)
 - ❖ **Purchases and payables**
 - ❖ **Closing stock balance** part of inventory valuation
 - **Purchases** typically subjected to additional testing through **controls testing**, and if necessary, vouching to **supplier documentation**
 - **Payroll expense** vouched to **time cards**, **employee lists**
 - ❖ Consider employees who **leave during period**

Adapted from Maroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley.

41

41

SUBSTANTIVE TESTING – COST OF SALES, EXPENSES

COMPLETENESS AND CUT-OFF

- Assertions combined – auditor to verify that client has **not understated expenses** and cost of sales by **deferring recording expenses** to next period
 - Examine **invoices around year-end** to verify dates
- **CLASSIFICATION** can be important for **special disclosure requirements**
 - For example, **interest expense**, **depreciation**
- **OCCURRENCE** not typically significant

Adapted from Maroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley.

42

42

SUBSTANTIVE TESTING – COST OF SALES, EXPENSES (Table 11.4)

OBJECTIVE	ASSERTION
All costs and expenses in the income statement are properly supported as charges against the entity in the period. Costs and expenses applicable to future periods are carried forward as inventory, pre-paid expenses, deferred charges or property, plant and equipment.	OCCURRENCE (O)
All costs related to the current period's revenues and all expenses of the current period are included in the income statement.	COMPLETENESS (C)
Costs and expenses are stated in income statement at the appropriate amounts and in the appropriate period .	ACCURACY, CUT-OFF (A& CO)
Costs and expenses are properly classified , described and disclosed in the financial report, including the notes.	CLASSIFICATION (CI) CLASSIFICATION AND UNDERSTANDABILITY (C&U)

Adapted from Mooney, Rubin, et al. (2017), *Auditing: A practical approach* (3rd ed.), Wiley.

43

43

SUBSTANTIVE TESTING – COST OF SALES, EXPENSES

- Processes impacting on costs and expenses
 - Substantive testing of purchases and payroll usually undertaken only if controls not effective, or if more efficient to test substantively
 - Testing of balances – some procedures ordinarily always performed, others if risk assessment warrants

Adapted from Mooney, Rubin, et al. (2017), *Auditing: A practical approach* (3rd ed.), Wiley.

44

44

SUBSTANTIVE TESTING – COST OF SALES, EXPENSES (Table 11.5)

PURCHASES PROCESS	PAYROLL PROCESS
Confirm accounts payable (not often performed). (E, V&A)	Compare the payroll at the beginning and end of the period to identify changes in employees and in pay rates. (A)
Test the cut-off by inspecting the purchases ledger, stock receiving records, creditor/supplier invoices and other supporting documents immediately before and after the cut-off date and determine that the transactions were recorded in the proper period. Compare payables cut-off to cut-off in related areas, for example, accounts payable and inventory. (CO)	Compare employee data (e.g. name, identification number, department, employee status or group, location, wage rate and deductions) to authorisations on file (e.g. hiring records, personnel files on wage rates and reductions, union contracts and tax file number). (O, A)
Perform a search for unrecorded liabilities as of the inventory date and/or year-end by selecting subsequent payments, unmatched invoices and stock receiving reports. (C)	Agree the record of hours charged, for example, timecards or job tickets to the payroll ledger/payroll software used to record and calculate payroll. (C, A)
Compare supplier/creditor invoices to the initial record of entry. (C)	Trace the payroll payments to the payroll clearing account. (O, A)

Adapted from Mooney, Rubin, et al. (2017), *Auditing: A practical approach* (3rd ed.), Wiley.

45

45

MONASH BUSINESS SCHOOL

SUBSTANTIVE TESTING – COST OF SALES, EXPENSES (Table 11.6)

EXAMPLE TESTS ALWAYS PERFORMED

Obtain detailed analysis of selected costs and expense accounts and trace the details to the source data. (O, A)

EXAMPLE ANALYTICAL PROCEDURES

Cost of Sales
Compare the current period's gross profit ratios by month, by location, by product and by geographic area with those of prior periods and with budgeted amounts. Investigate any large or unusual variations or the absence of expected variations. (C, A)

Expenses
Review the client's comparison of budgeted and actual costs and expenses by month or by quarter. Corroborate the reasons identified by the client for important variations. Investigate any unexpected variations or the absence of expected variations not identified by the client. (C, A)

EXAMPLE OTHER GENERAL PROCEDURES

Review the expense accounts in the general ledger for unusual items. Investigate any such items observed. (O, C, A)

Adapted from Monney, Rubin, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley.

46

MONASH BUSINESS SCHOOL

ASSESSING RESULTS OF SUBSTANTIVE PROCEDURES

- Other costs or expenses that could be significant include:
 - Administration costs
 - Selling expenses
 - Audit fees
 - Advertising and marketing costs
 - Impairment charges
- Nature of tests similar to purchases and payroll
- Use risk assessment based on knowledge of client and professional judgment to determine timing and extent of testing

Adapted from Monney, Rubin, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley.

47

MONASH BUSINESS SCHOOL

ASSESSING RESULTS OF SUBSTANTIVE PROCEDURES

- Auditor's objective is to determine if there are misstatements within the account balance and to quantify the amount of any misstatement
- If error identified:
 - Understand why it occurred
 - Consider increase to sample size
 - Consider additional testing
 - Continue testing until error can be accurately quantified or balance fully tested to ensure no error remains

Adapted from Monney, Rubin, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley.

48



EVALUATING, DOCUMENTING RESULTS

- Auditor **assesses impact of all errors identified** during the audit and documented in **working papers**
 - Distinguish between **errors (including fraud)** and **judgmental misstatements**
 - ❖ Differences in judgment between auditor and client
 - ❖ Likely to be **focus of discussions** between auditor and client, more likely to be 'range' than exact number
 - Decide if **one-off event**, or **systematic errors**
- **Conclude on results for each audit program step and each significant account and significant assertion**

Adapted from Mooney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

49