

# SUBSTANTIVE TESTING

Paul Merison concludes his two-part series on substantive testing with a series of tests

**I**n Part 1 last month, I covered some important understanding on the differences between control tests and substantive tests, and explained how audit tests are aimed at testing the assertions in the financial statements. Now it is time to use that knowledge to come up with some actual tests.

## Question types

If the examiner just asks for substantive tests (for example for receivables), aim to generate tests for as many assertions as you can. If the examiner mentions specific assertions then you need to get the test right. For example, to test **COMPLETENESS**:

- Pick something that should be included in the final total (for example an asset you can see the company is using) and check it is recorded in the final total (e.g. the asset is included in the asset register, and the asset register totals match the Financial Statements).

To test **EXISTENCE** or **OCCURRENCE**:

- Pick something that is included in the final total (for example an asset in the asset register) and go inspect the asset to prove it is in use. Note that Occurrence is the same concept – to test the reported sales revenue did **OCCUR**, get a breakdown of the annual sales figure, pick some individual sales invoices included, then go find the actual invoice, and ideally trace back to a Goods Despatch Note (GDN) and original Sales Order, just to make sure the reported revenue is real.

With the assertions above, the key is direction of test. Note how the tests are opposites – completeness takes something outside of the financial statements and checks to see it got included in the financial statements total, whereas existence and occurrence do the exact opposite.

To test **VALUATION**:

- Think what the accounting standards say about the item's value (e.g. inventory



at lower of cost or NRV) and then test that the rules have been followed:

- Agree cost back to a recent purchase invoice.
- Agree selling price to a recent sales invoice, or standard price list.

Before worrying about any more detail, make sure you understand the above three assertions and practice for each major item in a set of Financial Statements.

Then wait a few days and practice again – repetition is a proven study method to improve success!

Of course, to help explain technique I have focussed on some of the assertions, but not all. So now one other example:

To test **CUT-OFF** of sales revenue, find sales transactions just before the year end by locating the last few GDNs for the

year, and trace to sales invoice, making sure they are included in the sales day book before the year end. Now repeat for GDNs just after the year end, ensuring the invoices are **NOT** included before the year end.

## Writing your answer

The key here is **DETAIL**, not just getting the correct test to match the assertion.

Some very important rules for each test:

- Explain in enough detail that a new audit trainee could read your test and do it, without having to ask further questions about what to do:

- “Inspect board minutes” scores zero marks because the trainee does not know what to look for in the Minutes, or why.

- “Inspect board minutes to confirm directors agreed to settle the legal case for \$2m, to verify the existence of the obligation and its amount” will score marks as it is clear, and shows you understand the purpose of the test.

As a general rule for F8, whenever you identify an ethical threat, an audit risk, or a substantive test make a point of explaining why, not just stating it as if it is an obvious fact. This will demonstrate your understanding, but will also ensure your answers have sufficient detail rather than appearing to be a shopping list of four or five words each.

## Conclusion

Substantive Testing appears on every F8 paper and is very practical. So it needs a well-practiced technique if you are to score the marks. Before exam day you must:

- Understand the meaning of each **ASSERTION**.
- Practice generating tests for each balance in the Financial Statements, using AEIOU for ideas and matching to each assertion, and DADA3 to think up types of evidence.
- Remind yourself on exam day to **EXPLAIN** every test you suggest in enough **DETAIL** that an audit trainee could do the test. **PQ**

• Paul Merison is a lecturer at LSBF and the current PQ magazine Lecturer of the Year (private sector)

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