COLLEGE OF ACCOUNTING

AUDITING/CORPORATE GOVERNANCE | BASIC/INTERMEDIATE

Video Transcription: Control Testing

Hi there, my name is Mark and this video will be answering the question: How do tests of control relate to the audit of an account and disclosure, and how do they differ from substantive tests? Perhaps, as a start, we should remind ourselves what the point of audit testing is.

The purpose of an audit test is to allow the auditor to collect sufficient and appropriate audit evidence to be able to conclude on whether or not the financial statements are free of material misstatement.

Misstatements in the amounts and disclosures in the financial statements happen if the following three conditions exist:
1. An error has been made, or fraud has been committed
2. The controls the client has put in place do not pick up the error or fraud
3. The auditor doesn't pick up the error or material fraud

So, we can see that there are two ways that errors can be picked up; firstly through the controls management has put in place and, secondly, through the auditors finding errors when performing their tests.

If management has created, and put in place, good controls, the controls should result in there being less risk of an error going undetected. If this is the case, the auditor can reduce some of their audit testing. If controls are poor, the auditor will have to test more, since they are the only line of defence in finding errors.

We can illustrate this through an example. T-Shirt Company (Pty) Limited is a company that buys T-shirts and sells these T-shirts to large national clothing shops. At present, T-Shirt Company has very low stock levels, and is looking to order more to prepare for summer when T-shirts are in high demand.

A clerk in the Buying Department completes a purchase order for more T-shirts; this purchase order has to be approved by the head of the Buying Department before it can be submitted to the T-shirt supplier. Once approved by the head of the Buying Department, the clerk can send the purchase order to the supplier and await the arrival of the T-shirts.

After one week a truck full of T-shirts arrives at T-Shirt Company; a warehouse employee counts the number of t-shirts, ensures that the T-shirts are of the appropriate quality and, lastly, the warehouse employee checks that the actual T-shirts delivered corresponds to the T-shirts ordered on the purchase order from the Buying Department. Once the clerk has completed all these checks, he will sign and hand the documentation over to the warehouse manager, who will perform a second check and then sign the proof of delivery, or POD.

One week later, the accounting clerk receives an invoice from the supplier for the delivery of T-shirts. The accounting clerk immediately compares the invoice received to the POD from the warehouse, and then to the purchase order from the Buying Department. The clerk recalculates the invoice to ensure the total amount is correctly calculated. The clerk then signs the pack of documents, including the invoice, POD and purchase order, and forwards it on to the accounting manager who will perform a second check before authorising the invoice to be paid.

With the above controls, the risk that there is an error in the inventory balance is low. Let us analyse a section of the controls in place, in this process. A warehouse employee counts the number of shirts, inspects the quality of the shirts and compares what was delivered to the purchase order from the Buying Department.

Why does the employee count the number of shirts? Well, if the purchase order was for 100 T-shirts, even if only 50 T-shirts arrive, there is a good chance that the invoice that will be sent by the supplier of the T-shirts will be for 100 T-shirts. As all the documentation indicates 100 T-shirts, we would record the receipt of 100 T-shirts in the general ledger. So, if nobody counted the inventory, we would not realise that we had only received 50 – the amount of inventory, in the general ledger, would be misstated by 50 T-shirts.

Why does the employee inspect the quality of the T-shirts delivered? If the employee did not inspect for quality, some T-shirts could be of inferior quality, some may be damaged and some may be the incorrect colour. If this inspection did not take place, the company would have recorded all inventory received at cost, but in reality the inventory should either have been returned or should have been shown at a lower amount due to it being damaged or a lower quality than what was ordered. The value of inventory in the general ledger would therefore be misstated.

Throughout the example you can see that controls can stop errors and possibly identify fraud, which would prevent the annual financial statements from being misstated. As auditors, we rely on controls to minimise the amount of procedures we need to perform to detect errors and fraud. As we rely on the controls, it is important that these controls are tested.

So, how do we test controls? For the control where the warehouse employee inspects the delivery and signs the POD, we would be able to inspect the POD for evidence of his signature. The signature is evidence of the employee having performed the check. We would also be able to observe him, when a delivery arrives, and ensure that he performs the inspection.

For the control where the accounting clerk inspects the invoice and recalculates the total amount to ensure the invoice is calculated correctly, we, as the auditors, can re-perform or recalculate the total amount. We would also inspect the pack of documents submitted to the accounting manager to see if it includes the signature of the accounting clerk, proving that he completed the control.

From the example provided, you can see that controls are tested in the following manner:

- Inspecting, in other words looking at the documentation for evidence that a control has taken place
- Observation, so, actually watching to see if the control actually takes place
- Recalculation or re-performing a particular control or part of a control.

So, control testing is focused on the processes that create the numbers in the financial statements, and whether the controls that have been put in place to prevent and detect errors in the processes are actually operating. However, even if there are good controls in place and we have tested them, we would still need to perform a test directed at detecting if any errors or fraud had found its way into the financial statements. This additional testing, over and above control testing, is called substantive testing.

What is substantive testing? Substantive testing is focused on finding misstatements by focussing on finding errors in the actual numbers that are already in the financial statements.

Substantive testing could identify errors by using the following procedures:

- By looking at trends and patterns in the amounts that you know should exist for evidence of errors
- By confirming a bank balance with the bank or inquiry of the company with respect to a potential bad debt.
- By inspecting the relevant source documentation supporting an amount or disclosure
- By observing processes such as the year-end inventory count, to verify that the closing inventory balance exists.
- By recalculation or re-performance, an example would include test counting some items that the company counted during their inventory count to ensure they counted correctly.

So, with substantive procedures, the focus is on identifying an error in an amount in the annual financial statements rather than testing for evidence that a control takes place. Substantive testing focuses on the amounts and disclosures rather than the process underlying those amounts and disclosures.

So, as an auditor, if you know the controls were operating as intended, you know that there is less risk that an error or fraud has made its way into the financial statements. You can therefore spend less time checking for errors through substantive work.

Thank you for watching.