

A substantive DIFFERENCE



Alan Wan explains the difference between tests of control and substantive procedures, relevant to Audit and Assurance questions

A great many students struggle to distinguish between tests of control and substantive procedures. This is an area that is frequently examined, so it is essential that students feel confident about the difference. This short article will try and provide clarity between the two using a worked example.

Firstly, let's define the two procedures:

Substantive procedure

A substantive procedure is one that is designed to detect material misstatements at the assertion level (from the FRC glossary of terms, 2015).

There are two categories of substantive procedure: tests of detail and substantive analytical procedures.

Tests of controls

Tests of control are audit procedures designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level (from the FRC glossary of terms, 2015).

Substantive procedures are used by

the auditor to obtain direct audit evidence that the financial statement assertions (e.g. completeness, accuracy, cut-off, etc.) are materially correct. Tests of controls will provide indirect, probabilistic evidence that the figures in the financial statement assertions are materially correct. If the control environment is strong, errors are less likely to happen and are more likely to be detected if they do.

If the tests of controls indicate the internal controls are strong, the auditor is able to reduce the amount of substantive procedures needed.

Worked example

A local authority has a housing repairs and maintenance operation. They hold significant amounts of inventory, such as door knobs, bathroom shower units, window frames, paving slabs, sand, copper tubes, etc. The external auditor would be interested in the inventory balance at the year-end and the relevant assertions are: existence, rights and obligations, completeness, and valuation and allocation.

Assuming the local authority has a financial year-end 31 March 2018, the auditor will carry out the interim audit typically around January 2018. The final audit will be completed around July 2018. Additionally, for inventory, the auditor may attend the year-end inventory count at 31 March 2018.

At the interim audit the auditors will

carry out tests of control. The focus here is to ascertain whether the internal controls carried out by the entity are operating effectively.

For example, one internal control is that the audit client undertakes a monthly inventory count on the 31 January 2018. The auditor carries out a test of control, for example they could re-perform a re-count of a sample of the inventory items already counted by the client. Assuming the auditor is satisfied the internal control is operating effectively, this provides indirect evidence the inventory held on the accounting system is materially correct and the auditor can reduce the amount of substantive procedures at year end.

The external auditor usually undertakes substantive procedures a few months after the year-end to allow the client to close their accounts. Uniquely for inventory, the auditor usually carries out substantive procedures at two stages. Firstly, the auditor will attend the year-end inventory count at 31 March 2018, to carry out tests of detail, such as independently count (inspection) some of the inventory items. The purpose here is a substantive procedure rather than a test of control; the auditor is obtaining direct audit evidence whether the items in the warehouse accurately reflects existence, completeness and valuation of the inventory. That is, by inspecting a sample of inventory items, the auditor may disagree with the valuation of a batch of 20 shower doors, because 20% were damaged, so the original purchase cost of £100 x 20, should be reduced to £100 x 16.

The auditor may also carry out further substantive procedures at the final audit stage in July 2018. This could include an inquiry with the accountant about adjustments to the valuation of aged inventory; and substantive analytical procedures such as budget versus actual or inventory valuation comparison with a similar-sized organisation in the same industry.

The relationship between tests of control and substantive procedures is demonstrated by the audit risk formula.

• $\text{Audit Risk} = \text{Inherent Risk} \times \text{Control Risk} \times \text{Detection Risk}$

The auditors will establish the control risk by performing tests of controls to establish the strength of internal controls. If internal controls are strong, and hence control risk is low, the auditors can accept a higher level of detection risk, meaning fewer substantive procedures need to be carried out.

In reality, this could mean the auditor reduces their sample size of the number of warehouses to be audited at year end and for each warehouse the sample size of the items to be audited can be reduced. **PQ**

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