

1 The use of 'directional testing' in audit (Lecture A670 - 8.25 minutes)

Nowadays, most audit programmes are automated and set out various procedures to cover the relevant assertions (i.e. rights and obligations, completeness, occurrence etc). The concept of directional testing was an audit methodology which was developed in the late 1980's to provide a framework for the conduct of the individual audit assignment and all audits.

The term 'directional testing' is frequently used in the wrong context because the majority of audit tests (tests of controls and substantive procedures) necessarily have a 'direction' which is determined by the purpose of the test. Simply testing for, say, completeness and existence of certain transactions and balances without considering the other financial statement assertions does not constitute directional testing as either an audit methodology or an audit strategy.

Directional testing is of particular interest because it is a good example of an auditing methodology; it is conceptually straightforward because it is based on basic bookkeeping principles (debits and credits) and is still consistent with current 'best practice' which is reflected in the ISAs (UK), such as:

- ISA (UK) 300 *Planning an Audit of Financial Statements* which requires the auditor to plan and perform the audit in an effective manner.
- ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding of the Entity and Its Environment* which requires the auditor to gain an understanding of transactions pertinent to the entity.
- ISA (UK) 320 *Materiality in Planning and Performing an Audit* which requires the auditor to consider materiality (e.g. in determining the extent of audit procedures).
- ISA (UK) 330 *The Auditor's Responses to Assessed Risk* which requires an assessment of inherent risk relating to financial statement assertions about transactions and balances.

1.1 The use of directional testing

The concept of directional testing has its roots placed in the basic bookkeeping principle that every debit has a corresponding credit. If the trial balance balances (which invariably it does nowadays due to computerised bookkeeping) then there can still be a second misstatement.

Example – Misstatement within the trial balance

The auditor discovers that the client's trade debtors are overstated by £19,000. As a consequence of this misstatement:

- another asset is understated by £19,000 (i.e. if cash received has not been recorded); or
- liabilities are overstated by £19,000 (i.e. if the bank account is overdrawn and cash is not recorded); or
- revenue is overstated by £19,000 (for example due to incorrect cut-off procedures or invalid or incorrect invoices being processed via the sales ledger); or
- some other combination amounting to £19,000.

Directional testing works by testing debits in the trial balance for **overstatement** and credits in the trial balance for **understatement**. Therefore, by testing debits for overstatement, the matching credits will be tested indirectly for overstatement. By testing credits for understatement, the matching debits will be tested indirectly for understatement. Direct and indirect tests are often referred to as *primary* and *corollary* tests respectively. The primary tests interlock so as to give complete audit coverage.

Some auditors may ask if it is possible to use directional testing the other way around – i.e. test debits for understatement and credits for overstatement. This is permissible but the 'rule of thumb' is that it is applied in the former – i.e. debits are tested for overstatement and credits for understatement for the reasons outlined below:

- it addresses some of the more common errors which may arise in the balance sheet such as understating a liability due to oversight or deliberately and overstating an asset such as failing to recognise a bad debt provision;
- it helps to identify irregularities because a theft will often result in an overstatement of an asset or an expense – e.g. the theft of cash may be accounted for by writing it off to an expense account (or other asset account);
- it is more difficult for revenue/income to be overstated and it will be detected, where material, indirectly. For example, if a sales ledger clerk has overstated revenue by raising fictitious sales invoices, the debit (e.g. cash or a debtor) will be overstated which will be tested directly;

- a primary test for overstatement starts with the end result, i.e. the monetary amount stated in the accounts. The direction of testing is backwards to its source to confirm the occurrence and valuation of recorded transactions and the existence, valuation and rights to the asset; and
- the primary test for understatement starts at the source of the transaction (e.g. goods despatched notes) and traces transactions forward to the financial statements. These tests are aimed at ensuring the completeness and valuation of recorded transactions and balances.

Example – Trade debtors

The audit objective for trade debtors is to ensure that they are not overstated. Amounts due from customers will be overstated if, for example:

- cash received has not been posted to the customer's account; or
- a sales invoice is overstated or posted twice or raised incorrectly; or
- a credit note due has not been raised; or
- a bad debt has not been written off.

The auditor will direct their substantive procedures towards ensuring such errors have not happened. Therefore, a sample of customers are selected from the debtors list and are asked to confirm their balances through a debtors' circularisation and all discrepancies are investigated. For any non-responses, the auditor will test the make-up of the balance to supporting invoices, goods despatched notes and/or customer orders. After date cash received is matched against amounts due at the year end to verify valuation of debtors.

Example – Revenue and liabilities

The audit objective for revenue (sales) is to ensure that it is not understated. Revenue could be understated if, for example:

- goods have been despatched but not invoiced; or
- receipts from cash sales have not been recorded; or
- sales invoices are under-valued; or
- sales invoices raised have not been recorded in the sales ledger/revenue nominal.

When starting at goods despatched notes as the source of a sale the auditor should ensure (through tests of control) that goods cannot be despatched without a document being raised (i.e. a sales invoice or at least a goods despatched note). This is to establish the completeness of the population from which a sample of documents can be selected to trace through the accounting system. It is also possible to start the substantive tests over income from the customer's order.

The audit objective for liabilities is to ensure that they are not understated. For trade creditors, testing from the source document (the document which creates the liability) means starting with goods received. However, if this is not documented, for example on goods received notes, purchase invoices can provide the most complete population from which transactions can be tested. When a sample is selected from the other side of the entry (in this example purchases are debits but the actual test is a test for understated creditors), it is called the 'reciprocal population'.

For trade creditors, material understatement is usually likely to arise in respect of the largest suppliers who will have been identified in the testing of purchases for overstatement. Balances from supplier statements, if available, can be used to test for understatement. Note that just selecting a creditor balance from the ledger and ticking this to invoices and goods received notes will not test adequately for understatement. What you are concerned about is whether the entity has a liability that *isn't* recorded, therefore you must start from a population of items either external to the entity (such as statements from suppliers) or earlier in the workflow (such as goods received as mentioned above).

1.2 Stock (inventory)

Stock appears in both the balance sheet and the profit and loss account and hence is tested for both overstatement and understatement. When the auditor attends the year end stock count, they will test stock from the count sheets to the physical stock (which tests for **existence**) and from physical stock to count sheets (which tests for **completeness**). For directional testing purposes testing from the physical stock to the count sheets also tests that the amounts are recorded.

1.3 Testing the balance sheet in both directions

By conducting direct tests on assets and liabilities in both directions, complete audit coverage can be achieved (although careful consideration must be given to audit-related costs by doing this). Testing liabilities for overstatement is straightforward because suppliers' accounts can be selected from the trade creditors list and traced back to supporting invoices, goods received notes etc. When the auditor considers testing assets for understatement, they should consider how this could arise. For example, trade debtors will be understated if cash credited to a sales ledger account has not been received; or, if a credit note has been incorrectly raised. It will therefore be the credit entries in the asset accounts which are tested for their validity.

1.4 Testing the profit and loss account in both directions

Again, testing the profit and loss account in both directions will achieve complete audit coverage (again, consideration must be given to audit-related costs by doing this).

To test income for overstatement requires that recorded sales are substantively tested for occurrence. To test an expense for understatement will involve identification of its source and verification of its completeness. For purchases, this will usually involve tracing goods received notes through the accounting system. However, for many expenses such as rent, rate, depreciation and wages, completeness may be established through analytical procedures (e.g. a proof in total test).