DIRECTIONAL TESTING IN AUDIT

The overall objective of auditing is for the auditor to form an independent opinion on whether the financial statements of a reporting entity show a true and fair view. Auditors use various techniques to obtain evidence to support the amounts and disclosures within a set of financial statements. One such technique is that of 'directional testing'.

Directional testing was a technique developed in the early 1980s and it is not as widely used nowadays as it was when it was first developed. This is generally because other audit procedures (both of tests of controls and those of a substantive nature) have necessarily a direction which is determined by the purpose of the test. Having said that, it is still considered 'best practice' in auditing because it is conceptually straight forward and is a good example of audit strategy.

The basic concept of directional testing, which students of Unit 17 are required to understand is that it is based on double entry bookkeeping i.e. every debit has a corresponding credit. Consider this illustration:

The auditors of Alicia Inc have discovered that trade receivables are overstated by $5,000. This could result in:

- *another asset being understated by $5,000 (for example if cash received has not been recorded)*
- *liabilities being overstated by $5,000 (for example if the bank is overdrawn and the receipt has not been recorded)*
- *expenses being understated by $5,000 (for example discounts allowed)*
- *revenue being overstated by $5,000 (for example due to incorrect 'cut off')*

Therefore by testing debits *directly* for overstatement, the matching credit entries will automatically be tested *indirectly* for understatement. Conversely, by testing credit entries *directly* for understatement, the matching debit entries will be tested *indirectly* for overstatement.

A summary of the 'direct' and 'indirect' tests are as follows:

Note: (O) = overstatement and (U) = understatement

Account Type	Direct Test	Indirect Test			
		A	L	I	E
Asset	O	U	O	O	U
Liability	U	U	O	O	U
Income	U	U	O	O	U
Expense	O	U	O	O	U

Whilst directional testing works in this way:

Debits tested for overstatement; and
Credits tested for understatement

By definition, directional testing could work the other way in that credits are tested for overstatement and debits for understatement. However, debits are tested for overstatement and credits tested for understatement (the 'rule of thumb') because this direction addresses some of the more common issues that arise in the balance sheet (statement of financial position), such as:

- understatement of liabilities due to omission or oversight; and
- overstatement of assets due to carrying values being higher than recoverable amount, or failure to recognise impairments.

For example, it is generally more difficult for income to be overstated due to error/irregularity. If you consider a company that has raised some fictitious sales invoices towards the end of the year to boost revenue, profits and net assets in order to avoid breaching loan covenants imposed by its bankers, then because revenue is overstated, this must mean a corresponding debit (i.e. trade receivables) are also overstated. By using the 'debits tested for overstatement' rule, in this example the debits (trade receivables) will be tested *directly* for overstatement which will in turn detect the overstated revenues, if material.

Testing for overstatement (debits)
Testing for overstatement starts with the amount recorded in the financial statements. The auditor will then work backwards to its source to confirm the occurrence and measurement of the recorded transactions and the existence, valuation and the entity's right to the assets.

Testing for understatement (credits)
Testing for understatement starts at the source (e.g. goods dispatched notes) and then works through the transactions to their ultimate destination in the financial statements. These tests ensure completeness of recorded transactions and balances. See how the financial statement assertions come into this methodology. In order to make this method of testing viable, the auditor must consider all the financial statement assertions (rights and obligations, valuation etc) as opposed to simply testing for completeness and existence of certain transactions and balances.

Consider we are testing payables for understatement. We should start the testing with goods received notes. If these are not received then we should test purchase invoices. Such documentation is known as 'testing from source'. The source document in respect of creditors is what gives rise to the liability. When a sample is selected from the other side of the entry (i.e. purchases even though we are testing payables for understatement) it is known as the 'reciprocal population'. How the auditor designs which suppliers invoices/goods received notes fall into the sample is left to the auditor's judgement. However, often trade payables are most likely to be materially understated in respect of the largest suppliers who will have been identified when testing purchases.

Inventories

Inventory appears in both the balance sheet (statement of financial position) and the income statement so inventory is tested for both overstatement and understatement. The auditor will attend the physical stock count and test check items from the stock sheets to the physical inventory and from the physical inventory to the stock sheets.

Conclusion

It has been mentioned that students often lack an understanding of directional testing. This brief articles aims to highlight the basic principles that directional testing follows.

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