Excerpts from Chapter 7
Economical Testing Techniques

Key Topics in this Chapter:

- Practical steps for applying guidance on the nature, timing and extent of testing
- Suggestions for testing significant manual non-routine transactions
- Using update tests to ease the burden of testing at year-end
- Five ideas for the timing of control tests
- Types of control tests and when to use them
- Why the use of self-assessment tests should be minimized
- Maximizing your auditor's reliance on the work of others
- More inspiration on efficient testing

Companies have a variety of options available to them for testing and evaluating controls throughout the year. When planning Section 404 testing, companies should consider all the alternatives for the nature, timing and extent of testing, seek internal guidance, propose a course of action and then discuss the plan with their external auditor. In the end, tests of controls must evaluate the design and operating effectiveness of the controls over financial reporting and ultimately support companies' assessments.

Maximizing Your Auditor's Reliance on the Work of Others

In the past, auditors were reluctant to rely on the work of others in a Section 404 audit because of the requirement in AS No. 2 that auditors use their own work to provide the "principle evidence" for their opinion of a company's internal control. But in December 2006, the PCAOB introduced a new standard that removes many of the barriers to using the work of others in internal control and financial statement audits. The new standard is meant to supersede SAS No. 65 and it is called *Considering and Using the Work of Others in an Audit*

Based on direction in the new standard and proposed AS No. 5, external auditors can rely more on the work of others for walk-throughs, risk-assessments and testing of the company's internal control. Auditors use of the work of others will fall into two categories. 1) Using the work of others under the direct supervision of the auditor and 2) Using the work of others in the ordinary course of business.

Using the Work of Others Under the Supervision of the Auditor

The new standard on using the work of other allows for many more opportunities for auditors to use company personnel for portions of their internal control and financial statement audits. This in turn, provides a big opportunity for audit fee cost savings.

Practice Tip

At your annual audit planning meeting with your auditor, devise a plan for the auditor's use of company personnel during their audits. The cost savings in audit fees could be substantial and may even constitute hiring an additional employee or consultant to assist your auditor.

For example, you could hire a staff or senior level employee to assist the internal audit, SOX or other compliance function during the year and work directly with the auditors for their 10-Q, 10-K and SOX procedures. If your employee performs staff work for your auditor, the cost savings for a medium size company could be estimated as follows:

Number of staff hours for the year:	1,500
Percentage replaced by company personnel	50%
Potential hours saved	750
Per hour staff billing rate	$200
Potential savings	$150,000

Allowing company employees to work directly with your auditor could be a big incentive for accountants trying to obtain their license. Keep in mind, you can use employees or consultants to work under the direct supervision of your auditor. If you don't want to hire an employee full-time to work with your auditors at the quarter and year-end, you still could save by hiring a staff or senior level consultant on an "as needed" basis (most staff or senior consultants bill at lower rates than are charged by audit firms). In any case, incorporating your own people into auditor's work could provide substantial savings and more than cover the cost of an additional employee or consultant.

Qualifications

In using the work of others, auditors will be looking for personnel who are sufficiently *competent* and *objective*. These terms are subjective and auditors will be looking for the degree of competence and objectivity instead of making an absolute conclusion, Thus, the higher the degree of competence and objectivity, the more auditors will be able to rely on the work of others.

Practice Tip

Try to find a balance between the degree of competence and objectivity that your personnel can provide and how much your auditor will be able to use their work. There is no need to go over board. Hiring a staff level person with a lower degree of competence and objectivity may work better for your department (and budget) than hiring a more senior-level employee or consultant.

Auditors will be looking for the following attributes when evaluating competence and objectivity:

Competence

- Their educational level and professional experience;

- Their professional certification and continuing education;
- Practices regarding the assignment of individuals to areas of the business;
- Supervision and review of their activities;
- Quality of the documentation of their work, including any reports or recommendations issued; and
- Periodic evaluation of their overall performance.

Objectivity

1. Policies to address the individuals' objectivity about the areas being tested, and whether the policies are being complied with, including –
   i. Policies prohibiting individuals from testing matters related to areas which relatives are employed in important or internal control sensitive positions.
   ii. Policies prohibiting individuals from testing matters in areas to which they are assigned, were recently assigned or are scheduled to be assigned upon completion of their testing responsibilities. ("assigned" includes having supervisory responsibility for the area)

2. The organizational status of the persons responsible for the work of others, including –
   i. Whether the board of directors or the audit committee oversees employment decisions related to the responsible persons.
   ii. Whether the responsible persons have direct access and report regularly to the board of directors or the audit committee.
   iii. Whether the responsible persons report to a person of sufficient status to ensure sufficient testing coverage and adequate consideration of, and action on, the findings and recommendations of the persons performing the testing.

3. Policies designed to assure that compensation arrangements for individuals performing the work do not adversely affect objectivity, and whether the policies are being complied with.

Auditors may be able to use personnel whose core function involves permanently serving in a testing or compliance capacity, such as internal auditors, to a greater extent than personnel whose principal duties address other business objectives because they normally are expected to have greater competence and objectivity. Auditors are advised against using the work of individuals who have a low degree of objectivity, regardless of their level of competence and individuals who have a low level of competence regardless of their degree of objectivity.

Direct Assistance

Direct assistance means work that the auditor requests others to perform to complete some aspect of their work, such as tests of controls or substantive tests. When company personnel are providing direct assistance, the auditor should supervise, review, evaluate, and test the work performed by them just as they would their own staff. Additional guidance is described in AU sec. 311, *Planning and Supervision*.

Auditors' Use of the Work of Others in the Ordinary Course of Business

Auditors use of the work of others in the ordinary course of business is commonly seen in SOX projects when auditors use some of management's testing instead of their own. This usually is seen as two different scenarios:

1. Auditors use all of management's testing for a certain (usually low-risk) control performing a review of the testing workpapers and write-up. Or
2. Auditors review management's test results for a certain control in addition to performing some of their own, limited testing of the control.

How much they rely on the work of others will depend on several factors:

1. the objectivity of the tester,
2. the quality and reliability of the tests,
3. the competence of the individual,
4. the methods used in the tests and
5. the degree of risk of the controls

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Using Tester Objectivity to Increase Reliance

Greater reliance will be given to tests performed by internal auditors and consultants than to employees from the same department as the controls being tested. This does not mean that employees can not help with the testing effort. Employee testing should be carefully planned to encourage maximum usage of your external auditors reliance on management's testing.

Practice Tip

As a rule, process owners should not test their own controls and if possible, employees should not test controls performed in their own departments. Swapping testers from various business units provides increased objectivity..

For example, accounts payable employees from one business unit can test the accounts payable controls from another business unit. You will be able to maximize the benefit of testers that know the accounts payable processes at your company, but still have an increased amount of objectivity.

Another idea is to have employees from business units that are not in scope for your Section 404 program perform some testing in other areas to spread SOX work through out the company. The testing experience will help these employees in future years should their business units come into scope.

In general, external auditors will rank internal auditors or consultants as highly independent, employees from a difference business unit or department as medium independent, and employees from the same department as low in independence.

Practice Tip
It may seem illogical, but tester objectivity is not as big of an issue in high-risk areas. While you should always strive for competent, independent tests of controls, your external auditor will probably test high-risk controls themselves, regardless of the tester used by management. Focus internal auditors and consultants on the medium and low-risk areas to minimize external auditor testing of your controls.

Creating Quality Test Documentation to Increase Auditor Reliance

The amount of detail and relevant information in your test plans, how the test is performed and your test results will influence the amount of reliance your external auditor will place on management's testing. Make the testing documents easy to understand and concise for your auditor, giving them only the information they need to know. Keep the format simple and the descriptions detailed.

Writing Test Plans that a Monkey Could Follow

Test plans will be the guide for testers and a roadmap for your external auditor, and should contain all the information testers will need to complete the tests. Test plans should be written so that people with no knowledge of the process can understand and perform the test required. Simplify testing by telling testers exactly what they need to know, who they need to contact (both for the population report and testing), the name of the report that should be run and where documents are kept. Make the testing documentation specific enough that outsiders could perform the tests based on the descriptions in the test plans. In other words, the test plan should be so descriptive and easy to follow that a monkey could perform the test.

Practice Tip
If you are straightforward, simplify and add particulars to your test plans, you can have lower level employees perform testing. Your SOX team will need experienced auditors to write the tests and analyze the results, but your testers will not require audit skills if you are explicit in your instructions. Your testers can be less experienced and your costs can be reduced.

Information to include in your test plans is as follows:

- A number or reference to the control activity being tested
- The documents or specific report names needed and the person or position description that can provide the documents or reports
- The date range being tested
- The sample size to select for testing or a reference to the company's sample size guidelines
- A step by step description of the test to be performed

- The type of testing being performed (reperformance, examination, observation, inquiry, etc.)
- The name of the tester and date tested
- A workpaper reference column for any evidence included with testing results

Testers should receive a copy of the related control matrix and process narrative or flowchart for each area they are testing. A short exert from a sample test plan at a small company is below.

Control Activity	**Test Description**	**Type of Test**	**Tester & Date**	**Work Paper Ref**
234	A. Obtain a list of all monthly account reconciliations from the Staff Acct. Randomly select 30 reconciliations prepared from Jan-May05. For the samples selected, ensure that 1) reconciliations' ending balances tie to GL; 2) any reconciling items during the interim months are resolved by quarter end; 3) accounts are reconciled by Day 5 of the close and are reviewed by the Accounting Manager, as evidenced by signatures and dates; and 4) reconciliations have supporting documentation attached.	Reperf, Examin	Mary Smith 6/10/05	A.1 – A.5

Sample Sizes

The proper sample size is a crucial element in the testing process. Your external auditor may ask specifically how you selected your sample, what dates were covered, what was the population and the number of items sampled from the population. Sample selection and sizes will play a large role in management's assessment of its internal controls and whether your external auditor will rely on some of management's testing. As an example, your external auditor may not want to rely on a sample of two for a weekly control that was newly implemented in the last month of the year.

Samples are generally selected randomly to provide the conclusion that the control methodology is being consistently applied throughout the population. In internal control testing, as opposed to substantive testing, selecting a weighted sample or a sample of material amounts only will not provide the assurance that the control is being performed consistently for all transactions.

For example, if you only test approvals for purchase orders over $100,000, you may find the process to be effective because all big-dollar purchase orders are high profile and heavily scrutinized. However, if you examined small-dollar purchase orders, you may find the control to be lax because these do not have a spotlight shined on them. By testing a random sample, you can determine if all purchase orders are consistently approved according to company policy.

The goals in selecting sample sizes for testing are to a) ensure there are enough transactions tested to have confidence the remaining transactions are reflected in the sample results and b) not waste time reviewing too many items.

You should always exercise professional judgment when determining the extent of testing (and your sample sizes) based on the following criteria:

- Importance of the control for the business unit or department to prevent or detect misstatements
- Degree to which the control supports the effectiveness of other controls (i.e. general IT controls)
- Whether the control relies on performance by an individual or is automated (manual controls require more extensive testing)
- Frequency with which a control is performed
- The complexity of the control
- Whether there have been changes to the volume of transactions, the design of the control or key personnel

Parameters for sample sizes should include ranges instead of exact amounts so that sample sizes can be increased or decreased based on the factors discussed above. For example, you may need to increase a sample size for a control that has recently been changed.

Practice Tip
Publish sample size guidelines for initial testing and separate guidelines for update testing. Post them on an accessible site so testers can easily refer to them. Be sure to obtain auditor approval for all of your sample guidelines.

Testers must know that once a sample has been selected, items in the sample can not be replaced because they are missing or are known to contain errors. Missing or erroneous items should be marked as exceptions. Items already selected in a sample can only be replaced if they were inaccurately included in the population.

Using Standardized Sample Size Descriptions
Whether your testing is performed by employees, consultants or internal auditors, it is difficult to ensure that all sample sizes are adequately and consistently described in your testing documentation. Your external auditor will require these descriptions to be robust so they can determine if the company has sufficiently tested its controls as of year-end.

Practice Tip
Use standardized sample size language for all test documentation. Standardized descriptions should always be detailed and complete, describing how a sample was selected, the dates covered, the annualized population and the number of samples selected. Examples of such descriptions are as follows:

From the period of June 1 through July 31, 2005, there was a population of 200 account reconciliations prepared. The annualized population is estimated to be 1200. Because this control is considered medium risk, a sample of 40 was randomly selected based on the company's initial testing sample guidelines.

Or

The annualized population for account reconciliations is 1200. A remaining sample of 10 has been randomly selected for testing based on the update testing sample guidelines. The samples cover the period of October 1 through November 30, 2005. 10 of 200 occurrences for that period are being tested.

In addition to a description of how the sample was selected, be sure to include in your workpapers a list of each item tested.

Testing Results and Reliability

Just as in your test plans, testing results should be in a simple format with detailed descriptions. Do not make your auditor guess. Whether the test passed or failed, explain explicitly how the test was performed and which specific samples failed (if any). Your failed tests should have just as much (if not more) description as the tests that passed. Make copies of all exceptions to help clarify the error and include them in your workpapers.

Most importantly, be sure your testing is reliable. Whether to call a variance an exception or not sometimes requires judgment. Be conservative. Judge questionable results as you believe your auditor would and be sure that the conclusion that a control is effective is valid. Sketchy test results and conclusions can cause your auditor to question your testing. You will gain no benefit from your tests if your auditor concludes differently on a control's effectiveness.

Practice Tip

Be conservative in your analysis of control effectiveness and judge your results as your auditor would. Questionable test results and conclusions will reduce your auditor's reliance on management's testing.

Meaningful Exception Documentation

Thorough documentation of exceptions will provide support for your later evaluation of these exceptions as deficiencies. Although testers can usually explain the exception in detail, they may not be able to explain the underlying cause or impact the ineffective control will have on the financial statements. Process owners or department managers should review and clarify all possible exceptions to ensure they are true errors and not a misunderstanding of the tester.

Practice Tips

1. Have a standardized template to use for documenting confirmed exceptions. Have the tester fill out the exception description and the process owner and/or the

process owner's manager fill out the cause of the exception and if qualified, the impact it could have on the financial statements. This will help the process owner understand the error and take ownership for its remediation.

2. Process owners and Champions can estimate the impact an exception could have on the consolidated financial statements, but have them rate the exception as high, medium or low impact only. The decision to label an exception as a significant deficiency or material weakness should be made by your Section 404 program leader and the appropriate members of senior management.

3. There is no need for your external auditor to test controls that failed management's testing. Your auditor generally will not dispute management's conclusion that a control is ineffective. Be sure your auditor has your most recent test results during their own test period so they know which controls they can pass over.

Workpaper Methodology
Documentation of your testing efforts lays the groundwork for your external auditor's opinion on management's assessment. Initially, you may have decided to keep "hard copies" of your test documentation. However, just as with other business documents, it will save time and space to eventually keep your documentation in electronic form. In either case, the format of your test documents should be consistent. This was hard to achieve in prior years of compliance because companies usually had many different people performing their tests and consistency was not a priority.

Practice Tip
Establish a methodology for your test workpapers. Each control test documentation could start with a summary cover page listing the control, test procedure, tester, outcome etc., but it is not necessary to make copies of each report, invoice or statement sampled. Perhaps you can decide to always include copies of two samples, the first page of any report that was tested, and a copy of each document with an exception.

Be sure to discuss your workpaper methodology with your external auditor. There is a fine line between making too many copies and having your test documents readily available for your external auditor's evaluation.

For additional guidance for testing documentation, refer to PCAOB's AS No. 3. Though written for external auditors, management can use similar documentation techniques.

Why Qualifications of Testers Should Not Affect Reliance

Many companies use employees or a combination of consultants and employees for SOX testing. Most of these employee testers are not auditors and may not have accounting or finance knowledge . It is important to tailor your approach to your testers in case they are not experienced or do not have an audit background. If employees are properly trained and monitored, and your test plans "are written for monkeys", there should be fewer issues with qualifications or competence.

Practice Tip

Actual testers do not always have to have the qualifications your external auditor would like in order for them to rely on management's testing. Although testers may be inexperienced, they should be well trained and have descriptive and thorough test plans. The people who write the test plans, monitor the testers, review the results and analyze the effectiveness of controls should have the qualifications your auditor is seeking.

Away from Internal Audit and Towards Process Owners

Moving testing away from internal audit and Section 404 teams will allow internal audit to focus on their other responsibilities and give more ownership to the employees that perform and monitor the controls. Perhaps having the process owners absorb the bulk of the testing will also result in the costs being absorbed, dissipated and reduced overall.

Whether you will have internal audit, consultants or process owners perform the majority of internal control tests, document the testers, their level of independence and the company's methodology on the level and independence of testers. Be sure to include internal audit's monitoring and review of your SOX testing, because they will (generally) have the qualifications required to ensure your testing and documentation are adequate for management to conclude on the effectiveness of its internal controls.

Increasing Reliance with Persuasive Testing Methods

Management can use a multitude of methods to come to a conclusion on the effectiveness of its internal controls. However, the methods management uses for testing will directly affect the amount of reliance your auditor places on your testing. The less assurance provided by your testing, the less reliance by your auditor.

For example, inquiry and observation testing can be used by management as sources for their opinion on internal controls. However, because these methods offer little assurance that controls are operating effectively, your auditor will rely less on management's testing if these methods are used. Using alternative testing methods and auditor reliance is a balancing act. Nevertheless, the more the company moves away from a traditional audit approach, the more the external auditor will want to do of their own testing.

Reliance and Control Risk

External auditors may use the work of others, but will perform much of their own testing as well. What areas would you test if you were required to choose certain processes? Your auditors will most likely test controls surrounding the high-risk processes that are complex, subjective, have had errors in the past or relate to period-end adjustments.

Although many barriers have been removed for your auditor's use of the work of others, their responsibility to report on a company's financial statements and internal control rests solely with the auditor and cannot be shared with the other individuals whose work the auditor uses.