
Testing to meet today's demands for greater assurance – How much is enough?

By Karen Titus, KnowledgeLeader contributing writer – www.knowledgeleader.com

At a time when financial reports, business processes and controls are coming under closer scrutiny, audit directors are placing renewed emphasis on evaluating the nature, extent and timing of audit testing. The issue of testing can present many challenges, particularly due to a general lack of guidelines concerning how much testing is enough and to what depth testing procedures should penetrate the enterprise's control processes.

"Internal auditors have always tested," said Jodi Swauger, assistant vice president, Research and Education Group, Institute of Internal Auditors (IIA). "But in today's environment, management and audit directors are a lot less comfortable with degrees of assurance that may have been perfectly acceptable in the past. So while testing is not new, the growing level of interest in testing clearly is."

"When you talk about testing, you're getting back to the level of assurance that you need as an internal auditor, and that management wants, at a time when the reliability of process controls is under greater scrutiny than ever," said Urton Anderson, Ph.D., professor of accounting at the University of Texas at Austin. "You also have to consider what audience you are providing the assurance to. Are the results of the test intended for an internal auditor audience, the process owners and others being audited, or management? Usually, your audience is going to be management, since that is the entity seeking the most assurance.

"It also depends on the materiality and complexity of your environment, the number of systems you're dealing with and the controls you have in place," Anderson said. "What are the risks associated with non-compliance? Finally, what is the cost of the testing process and will the benefits be worth it?"

Nature, extent and timing

"When approaching the testing process," said Jim DeLoach, managing director, Protiviti, Houston, "internal auditors should focus on three characteristics: the nature of the test, the extent of the test and the timing of the test."

The nature of the test refers to the kind of test the auditor is planning to execute, whether a judgment-based test, statistical sampling or some combination of approaches. The extent of the test relates to the sample size and the number of items to be tested, i.e. the depth of testing. Timing deals with the scheduling and frequency of testing. DeLoach points out, "The question the auditor must ask is: 'Do I want to infer the results of the test to the population?' The answer to this question is usually a function of the auditor's objective in performing the test. The answer has a significant impact on the auditor's decisions with respect to nature, extent and timing."

The tools and methodologies of the testing process are essentially the same as those used in a typical internal auditing engagement. These include:

- inquiries of appropriate process and control owners,
- inspection of relevant process documentation,
- observation of processes and controls in operation and
- re-application or re-performance of the operation of the control.

"The most effective way for the internal auditor to decide what needs to be tested is simply by identifying the organization's key controls," said Larry Rittenberg, professor of accounting and information systems, University of Wisconsin at Madison. The key controls are the ones that address your important risks. "Once that is done, the rest is simply deciding the level of reliability you need and the size of sample you intend to use."

It also helps a great deal to begin the year with an audit plan that explicitly includes a testing component.

"The audit director should step back and look at the audit plan for the year," said Hartley. "Testing should be built into the plan, along with the other factors that contribute to the overall assurance provided to management. These could include a quality control program and other features that can contribute to management's comfort levels."

"One important factor that will have a bearing on the testing plan is the stability and overall strength of the control environment," DeLoach added. "The control environment takes into account such components as historical experience, the tone at the top, the emphasis that management places on internal controls, the entity level monitoring that is taking place and the transparency of the performance of the internal controls in a specific area."

"The stronger your control environment, the less testing will be needed to satisfy yourself that you are providing management the degree of assurance it needs," DeLoach added. "Conversely, the weaker your control environment, the more extensive your depth of testing will need to be."

According to Swauger, another factor that can be of particular importance to the testing process is a commitment to good documentation.

"Documentation is critical," said Swauger. "Management today is looking for greater assurance from the internal audit process, and internal auditors' work is being more closely reviewed. Once you've decided what you are going to test, make sure you are adequately documenting the process."

When is enough 'enough?'

But if there are no hard and fast guidelines for all situations, how deep should the process go and how much testing is enough?

Some internal audit directors will pursue a phased approach to testing, conducting a so-called 'Tier 1' testing program of major control indicators. If the Tier 1 test uncovers exceptions, a more thorough 'Tier 2' test is called for.

"Whether or not to conduct a Tier 1 or Tier 2 test is really a judgment call," Swauger said. "This is where the experience and training of the internal auditor becomes even more important. For instance, in the case of fraud detection, most auditors will develop a 'nose' for when things are not right. Similarly, most experienced auditors will tend to know when the testing process has gone far enough. If any questions remain, they can consult with their external auditors, who can provide some additional guidance and act in a proactive advisory role."

"It all depends on what level of reliability you need," said Rittenberg. "In my experience, statistical sampling methods will always render the best insights, although it is the most intensive type of testing. A sample of 30 to 40 indicators may not be sufficient. It may be prudent to double or triple that size, which puts you back in the neighborhood of a more thorough statistical sampling approach. My view is that to achieve a reliable test result, you must have a sample size large enough to be representative of all the key types of control systems the test will encounter."

"The key to reducing the size of your sample is developing a full understanding of your control systems," Rittenberg said. "You can narrow the scope of your testing by understanding and focusing on your key controls, which is why it is absolutely fundamental for the organization to thoroughly understand the risks that its particular kinds of controls are designed to address."

Format of final report may influence testing mode

According to DeLoach, the type of report the internal auditor will generate at the conclusion of a test may be one of the determinants of the nature, extent and timing of the testing program.

"There are at least two types of reports that auditors may be asked to provide at the conclusion of a testing program," DeLoach said. "Under the first type of report, the auditor works with the management sponsor to develop a test plan outlining the testing procedures with very specific objectives. In this case, the sponsor typically assumes responsibility for the adequacy and depth of the procedures. The auditor is simply executing a plan approved by the sponsor and reporting on the results. As the auditor, I am not inferring anything from the findings. I'm simply telling management 'here's what you asked me to do, here's what I did and here's what I found.'"

"In other cases, the auditor is expected to test and thoroughly evaluate the effectiveness of the control being examined," DeLoach added. "Under this scenario, my testing has to be sufficient to enable me to infer the results to the entire population. Hence, the depth and scope of my sampling has to be sufficient to satisfy me that the controls are operating effectively. That's where the professional judgment of the auditor comes into the picture, which is also why there simply aren't any 'holy grails' out there with regard to testing guidelines."

Testing and Sarbanes-Oxley

"Sarbanes-Oxley has absolutely had a major impact on testing," said Rittenberg. "In my 30-plus years associated with the internal audit field, I have never seen the emphasis on testing that I am seeing today. This is not a bad thing, but it is a mindset that can lead organizations into believing that everything needs to be tested, which is not the case."

Organizations and internal auditors need to do more analysis up front so that they can be sure they are testing key controls that really need to be tested, whether for Sarbanes-Oxley compliance or any other purpose."

"The real challenge has been the lack of guidance about Sarbanes-Oxley related testing," said David Hartley, director, Protiviti, St. Louis. "There hasn't been a lot of guidance available to management with regard to testing. And it is management that will determine the level of comfort it is willing to live with in today's environment, which in turn will determine the depth of testing required."

"Sarbanes-Oxley basically means attaining a different overall level of assurance," said Anderson. "The question is what will it take to provide an acceptable level of assurance to address the concerns of management and the internal audit function? It has changed what management wants and expects from the internal audit function. Top managers want assurance that when they sign that statement they can do so knowing that the internal controls have been effective. In that respect, this is a new task for the internal auditor."

"In a sense, Sarbanes-Oxley requires us to step back and reassess our mission and focus and to take another look at the charter of internal audit," Hartley said. "The climate and regulatory focus today requires auditors to look more closely at 'entity level' issues, such as tone at the top and other softer, business ethics issues. The changing business, ethical and internal audit environment exemplified by Sarbanes-Oxley is going to motivate many internal auditors to re-evaluate the depth of testing -- a process that is bound to continue."

Auditors seeking additional guidance on Sarbanes-Oxley issues, including testing, can access Protiviti's "*Guide to the Sarbanes-Oxley Act: Internal Control Reporting Requirements* -- [Frequently Asked Questions Regarding Section 404](#)."

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