

SECTION 2
CHAPTER 4
EVALUATING DESIGN AND OPERATING EFFECTIVENESS

Evaluating the design and operating effectiveness of internal controls involves three steps that are used to test all key controls needed to support management's assurance statement on internal control over financial reporting:

- Assess the design of key controls
- Define and document the testing approach
- Test the key controls

EVALUATE THE DESIGN OF KEY CONTROLS

Evaluate the key controls and determine if they are designed to prevent or detect material errors or misstatements related to an account or group of accounts. The design of key controls may be evaluated through interview, inquiry, and/or observation of the controls. Select transactions subject to the control and evaluate whether the design of the control would detect any errors or misstatements, assuming the control was properly executed. Key questions to consider include¹²:

- How could potential misstatements in significant financial reporting processes affect the related line item or account at a financial reporting assertion level?
- How does the related control objective prevent or detect the potential misstatement?
- Are identified control techniques likely to achieve the control objectives?

The reviewer should document the results of the evaluation of design in a memorandum that includes 1) the name and contact number of any person interviewed, the specific items selected for evaluation, the results of the evaluation, and his or her conclusion regarding whether the control is designed properly and 2) was it effective, moderately effective, or not effective. The documentation memorandum should note an identifying number, amount, and date for each transaction reviewed, and be written in sufficient detail to enable someone of similar knowledge to reperform the evaluation using the same items.

Testing is not needed if a control over a significant account or group of accounts is missing or the design is not suitable to the associated risk. Instead, absent or unsuitable controls should be noted in a list of deficiencies and suggested for improvement with enough space to note the nature of the deficiencies. Further testing of transactions subject to such controls help determine if any actual loss, fraud, error, improper payment, or noncompliance occurred.

DEFINE AND DOCUMENT THE TESTING APPROACH

Test if key controls that were deemed effective or moderately effective function as they were designed. The test determines the extent to which the controls were applied, the consistency of their application, and who applied them. To ensure that all key controls are tested, use a testing approach that defines the nature, timing, and extent of testing necessary to provide sufficient evidence to support management's assertion. This requires that the TCMs, flowcharts, and internal control matrices be reviewed; the controls to be tested be listed in a test program with

¹² Page 28 in CFO Council's *Implementation Guide for OMB Circular A-123, Management's Responsibility for Internal Control, Appendix A*

the nature, timing, and extent of testing for each control defined; and the controls in the test program be cross-referenced with the memos, flowcharts, and control matrices to ensure all are tested. The testing should address both manual and automated controls. When the IT control environment is considered effective, greater reliance with less testing may be appropriate for those automated controls as compared to manual controls.

Nature of testing. An acceptable testing procedure should be developed for each key control. Acceptable tests include:

- Inspection of documents, reports, or electronic files demonstrating control performance
- Reperforming the application of specific controls
- Observing the application of specific controls in operation
- Inquiry of appropriate personnel
- A walkthrough tracing a transaction from origination through the information system until the transaction is reflected in the financial reports. A walkthrough encompasses the entire process of initiating, authorizing, recording, processing, and reporting individual transactions and controls for each significant process.

Evaluation at the Departmentwide level is generally accomplished through observation, inquiry, and inspection, rather than the detailed testing that lends itself to the transaction or process level internal controls. Questionnaires and checklists are most useful at this level. Adapt the Department's automated survey and assessment tool based on the GAO Assessment Tool for evaluation of internal control to assist in assessing internal control at the entity-wide level.

Tests of design at the process level are usually performed by inquiry and observation; or inspection of documents, such as reports and completed forms; or through on-screen prompts, such as errors or warnings. Tests of design typically address the:

- Type of control, including configuration, management review, and authorization
- Nature of the control (i.e., automated or manual, preventive or detective)
- Frequency of the control (e.g., daily, weekly, monthly)
- Experience and competence of the individual performing the control
- Error investigation and correction procedures, including the timeliness of such procedures. It is important to note that inquiry alone ordinarily is not sufficient to support design effectiveness.

Timing of testing. Testing should be schedule throughout the year or quarterly for those controls that coincide with preparation of quarterly financial statements to OMB. Certain financial reporting controls have traditionally only operate at year-end, so there is only one opportunity to test and no opportunity to remedy failure. Consider implementing them during the quarterly financial reporting process, so time is available for remediation and verification.

Extent of testing. The selection of locations for testing should consider the risks of error and materiality. The locations and extent of testing should be documented in the test plan, and signed off by the affected process owners. The extent of testing also depends on the risk of failure of the control defined as the risk of a material misstatement arising from the failure of a control. If it is believed there is a high risk of failure, expand the extent of testing for that control. Factors that affect whether the control may represent a higher risk of failure include:

- Changes in the volume or nature of transactions
- Changes in the design of controls

- The degree to which the control relies on the effectiveness of other controls
- Changes in key personnel who perform the control or monitor its performance
- Degree to which the control relies on an individual's performance rather than automation
- The complexity of the control

Statistical and judgmental sampling may be used to limit the number of transactions and other items tested, yet ensure the testing is adequate for the conclusions to be drawn and provide sufficient evidence to support management's assurance statement. Statistical sampling may be the most efficient approach for tests of complex controls (e.g. several locations, many samples throughout the year). The GAO and AICPA offer statistical sampling approaches for financial statement audit purposes that may be used alone or in combination with judgmental sampling.

To determine the sample size for controls at various locations, the auditor uses judgment to determine three factors: the confidence level, the tolerable rate (maximum rate of deviations from the prescribed control acceptable without altering the preliminary assessment of control effectiveness), and the expected population deviation rate (expected error rate). Once these factors are determined, software such as Interactive Data Extraction and Analysis (IDEA) or tables are used to determine sample size and how many deviations may be found without having to change the control risk assessment. Developing a representative sampling plan may require the use of a qualified statistician to define expected error rates and the level of confidence obtained from actual error rates.

TEST THE KEY CONTROLS

Test the controls are operating effectively and the assertions valid compared to the acceptable level of error documented in the testing plan. Determine whether the controls have been applied adequately using a sample of transactions processed throughout the period as indicated in the sampling plan. Samples should be selected from the complete population of transactions for which controls are to be tested. Detailed documentation of the reperformance of transactions or controls will determine if the controls perform as designed and allow others to duplicate the reperformance if needed.