

MANAGER'S GUIDE

**TESTING COMPLIANCE WITH
INTERNAL CONTROL REQUIREMENTS**

**New York State
Division of the Budget**

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MANAGERS' GUIDE

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I. INTRODUCTION:

An internal control review determines whether controls are functioning as intended by:

- **Evaluating** whether procedures are designed to achieve the goals of the function and the control objectives.
- **Testing** whether procedures are being followed.

Testing, or **Compliance Testing**, determines the extent to which staff follow prescribed policies and procedures in actual practice -- it compares procedures as executed against required or expected procedures. Testing provides objective evidence on how well controls are executed.

Testing is not intended to repeat or replace normal, ongoing management controls which assess how well an organization follows procedures and meets control objectives. For example, in the course of business (e.g., regular use of management information systems and regularly scheduled consultations with staff), management often reviews functional output information (e.g. average waiting time in DMV lines, number of community residence beds created vs. the established goal) which discloses the level of success in achieving specific control objectives. In such cases, it is not necessary to also test these objectives through an internal control review -- management already knows whether or not these objectives are being met. The testing described in this guide is aimed at instances where other management control procedures do not adequately reveal how well controls are being executed.

The following guidelines describe a suggested testing process. It assumes that the manager has already executed the evaluation portion of the internal control review (i.e. evaluating the adequacy of procedure design) and is now ready to determine the degree to which procedures are actually being followed.

II. STEPS IN THE TESTING PROCESS:

STEP 1: Identify transactions to be tested and the key controls which support each transaction.

A. Transaction Identification

To select the transactions to be tested, the manager should review his/her vulnerability assessments and reflect upon each function's mission, important operations, controls and areas of potential weakness.

The highest priority areas to be tested are those which are most important to control and which may be subject to the greatest risk of breakdown. The following criteria should help identify this level of risk:

- Magnitude of resources controlled by the function.
- Susceptibility to fraud.
- Liquidity of assets.
- Degree of technological complexity.
- Sensitivity of transactions.
- Interdependency on other functions.
- Extent of regulatory agency involvement.
- Importance of the function to the organization.
- Past audit findings.

B. Key Controls

Once an area has been selected for testing, review the key controls identified during the evaluation phase of the internal control review. Such key controls are those steps which are most critical to achieve the control objectives of the function. Key controls can be identified by reviewing the procedure and identifying the steps which, if not executed, could result in the failure of the procedure to meet its primary goals. Such steps can be identified by asking the following questions:

- What are the most important procedures which keep the process on track?
- Which steps help ensure that only valid transactions are processed (e.g. supervisory authorization of transactions)?
- Which measures are designed to detect important errors and irregularities (e.g. monthly accounting on the use of pre-numbered forms, review of on-line access and transaction logs, and reconciliation of reports to control logs)?

STEP 2: Determine the standards that apply to the transaction to be tested.

A test cannot be successful unless the expectations for performance of the transaction are known. Testing can only proceed when the manager knows or establishes specific, measurable goals and objectives. Where they are absent, the manager should develop such standards, consulting with other managers and supervisory levels as needed.

Standards are found in directives, procedure manuals, laws, mandates, job descriptions and job specifications. Examples of standards are:

- Competitive bids are obtained for all procurements over \$10,000.
- Engineering designs conform to a prototype design book.
- Construction change orders are approved by a supervising engineer.

- Reports on client status are filed on a monthly basis and must be approved and initialed by a supervisor.
- Computer program revisions are only made by an authorized programmer with the approval of the head of the EDP unit.
- Medication is dispensed by an authorized medical technician pursuant to a signed medical order.
- Field visits to facilities or clients occur on a monthly basis in accordance with an annual plan.

STEP 3: Select the test method.

Testing measures **actual performance** of procedures against **expectations**. There are three primary approaches:

A. Sample documentation of the transactions using files, logbooks and other documentation sources.

B. Interview staff to learn the process they follow to complete the task.

C. Observe the procedure in action.

In all three cases, the manager is probing whether actual operations are faithful to the established process.

To determine the best method to test a particular transaction, review the degree to which execution of key controls is reflected in the record of transactions. If the process is heavily documented, and such documentation seems fairly complete, use **sampling**. However, if some or all of the key controls are not customarily reflected in the documentation, **interviewing** or **observing** staff may be the only feasible method for testing. Often, it may be appropriate to use a combination of test methodologies.

STEP 4: Determine how much testing is necessary.

The decision on the number of staff to observe or interview or the number of documents to sample is best left to the judgment of the manager. To decide how extensive the test sample should be, the manager needs to consider the number of transactions involved in the function (e.g., the number of contracts, billings, reports or change orders) and the type of documentation supporting each transaction. There are a number of other aspects to consider:

- Importance of the process.
- Volume of transactions.
- Complexity of the procedure.
- Amount of dollars at risk.
- Frequency with which changes have been made to the procedure in the past.
- Number of key control points in the procedure.

- Size, location and diversity of the organization executing the procedure.
- Margin of procedural breakdown which can be tolerated.
- Difficulty of judging whether the procedure is being adequately followed.

Finally, the cost-benefit of the testing should be analyzed. Testing should be as efficient as possible -- only perform enough to gain a reasonable sense of whether the procedure works. Assess what is feasible to be tested in the time available and focus attention only on the key control areas to be reviewed.

STEP 5: Plan the testing process.

Before beginning the test, the manager should confer with ICO staff, the internal auditor and any fellow employees who have conducted testing to obtain advice on appropriate testing techniques, selection of instances to test and documentation of test results. Consultation with the ICO or his/her staff before, during and after testing will help maintain quality. Finally, the manager prepares a written plan which explains **what** will be tested and **how** it will be tested. The testing plan should specify:

- Whether the manager will conduct the tests or delegate all or part of the testing.
- When the testing will be scheduled.
- How the records (for sampling of documentation) or the employees (for interviews and observation) will be selected.
- How the testing will be documented.
- How the results will be evaluated and findings developed.

The manager should review the attached form and plan to use it or a similar form to document the process.

STEP 6: Conduct the Tests

When selecting the staff to be interviewed or observed or the documents to be reviewed, be impartial and objective. From the group of staff who could be interviewed or observed, or the documents which could be sampled, select randomly to ensure that:

- A cross-section of the staff among those who follow the same procedure are interviewed or observed. The staff selected should not be limited to those with the most or least experience with the process or those from only one organizational section of the group executing the procedure.
- Testing is not limited to transactions from only one point in time. For example, testing intended to represent a year's worth of activity should not be limited to transactions processed only in December.

If the plan proves to be unworkable, it should be modified. If initial testing suggests substantial non-compliance, the size of the test may be expanded to help identify the

scope of the problem. If non-compliance is widespread, the testing should stop and the procedure should be evaluated to learn why it has failed so extensively.

STEP 7: Document and assess test results.

A. Document the Test

Consistent with the testing plan, maintain sufficient records of testing to explain the findings and demonstrate how often the key controls were not followed. This information might include the following:

- Rationale for testing plan.
- Key control points tested or procedural steps followed.
- Personnel interviewed.
- Observations performed.
- Identification of the instances where non-compliance was discovered.

The manager conducting the tests should use the record referred to in Step 5- or its equivalent - to record test results.

B. Assess Results

Use testing to learn whether, and how frequently, the procedure was not followed. Determine if any lack of compliance was confined to one part of the process or one group of staff or to one period of time--i.e., make a judgment on the extent of the non-compliance. Most important, the manager decides whether any evidence of non-compliance discloses significant operating weaknesses. He or she then assesses the importance of such weaknesses by considering their causes and effects.

1. **Cause:** identifies the responsibility and reason for the deficiencies. A cause could be a continuing practice or a single event. The following are some questions to consider in determining cause:

- What created the weakness? What were the circumstances that resulted in the reported problem or condition?
- Would the problem or condition have been identified if the test had not taken place?
- What practices were absent that should have been present? Was the problem a violation of established procedures? Were there any valid reasons for not following the procedure?
- Why does the problem exist? Was it an isolated incident or an indication of a continuing operational deficiency? Could the weakness occur again?

- Was the problem a minor human error, or did it reflect operational weakness or inadequate supervision?
- Was the weakness a result of inadequate or insufficient operating instructions?
- At what level does the problem exist?

2. **Effect** determines the significance of the weakness identified through testing. It helps to determine the materiality of the weakness by reviewing its effect on the everyday functioning of the operation being tested. The following are some examples of effect:

- Revenue losses or unnecessary expenses.
- Inefficiency or waste.
- Failure to achieve stated objectives.
- Inability to comply with laws, rules and regulations.
- Failure to fulfill reporting requirements satisfactorily.
- Physical loss.
- Adverse publicity.

When evaluating this information, the manager needs to apply a cost-benefit standard to any actions suggested to remedy apparent deficiencies. Any revision in practice - especially any additional expenses for stronger controls - should lead to financial savings or other operating improvements whose value is greater than the increased investment.

STEP 8: Testing follow-up: preparation and execution of a corrective action plan.

As noted in the introduction, **Testing** reveals weaknesses in execution of a procedure while **evaluation** reveals weaknesses in its design. Together, these two processes identify problems which need to be corrected. It then becomes management's responsibility to develop a Corrective Action Plan which identifies all the planned corrective actions, responsible personnel and target dates and establishes a process to monitor execution of the plan.

Attachment

ICR - TESTING RECORD

Agency/Division _____ Office/Unit _____ Function/Procedure _____

Individual Conducting the Tests _____ Telephone Number _____

Reviewed by _____ Date _____

Brief Description of The Key Control Points Being Tested	Testing Process: Describe The Process Used To Test Whether The Key Control Points Are Being Followed	Sample Size: Describe The Number of Staff Interviewed; Transactions Observed, or Documents Sampled and Universe	Describe The Results Of The Test, Stating Whether No Problems Were Found or the Weaknesses Discovered and Estimate the Frequency of Failure In the Procedure	Analyze The Weaknesses Uncovered: Cite the Source of the Failure And the Possible Corrective Actions