Tests of controls

MODULE 3 | 3.2.1 | STUDENT COMPANION

A **test of controls** asks whether a control operated effectively **throughout the period of reliance**: how it was applied, how consistently, and by whom or by what means. That goes beyond Module Two's check of design and implementation. Enquiry must be combined with **inspection, observation or reperformance**. **Automated controls** can be tested lightly when the general IT controls show the program didn't change. Interim testing needs evidence for the rest of the period, evidence from earlier audits can be used only within limits, and controls over **significant risks** are always tested in the current period. Every **deviation** must be understood before deciding whether reliance still makes sense.

Design and implementation, or operating effectiveness?

Design and implementation (Module Two)	Test of operating effectiveness
• **Design:** could the control, as designed, stop a material misstatement, or find and fix one? • **Implementation:** does it exist, and is the entity actually using it? • Usually one walkthrough, at a point in time	• Did it operate effectively **throughout the period** the auditor intends to rely on it? • **How** was it applied at different times during the period? • Was it applied **consistently**? • **By whom**, or by what means?
Only test well-designed controls Testing a badly designed control only proves that a bad control was followed	**Deviation** A control that didn't operate as designed, whether or not a misstatement actually resulted

Why test controls at all? Testing controls is a choice the auditor makes when relying on them will reduce the substantive work, and a necessity when substantive procedures alone can't give enough evidence, as in highly automated processes with no paper trail. A walkthrough shows that a control exists; it says nothing about the other days of the year.

Ways to test whether a control operated

Enquiry	Inspection	Observation	Reperformance	Computer-assisted techniques
Ask the people involved how the control works and what they do with exceptions **e.g. asking the sales manager how discount approvals are handled**	Examine evidence that the control was performed **e.g. a manager's electronic approval on a discount; a signed, reviewed bank reconciliation**	Watch the control being performed: useful when it leaves no trail **e.g. seeing how duties are actually split between depot staff**	Carry out the control again, independently **e.g. redoing a reconciliation; following up items on an exception report**	Test the controls built into software directly **e.g. test data and similar techniques (next lesson)**
Never enough on its own	**Good, where the control leaves a trail**	**Shows only what happened while the auditor watched**	**Strong evidence**	**Direct evidence about the program**

Strongest in practice: enquiry combined with inspection or reperformance

One perfect performance proves little. Watching a control performed well on one afternoon shows it worked then, while someone was watching. For the rest of the year the auditor needs evidence that leaves a trail, or repeated observations at different, unannounced times.

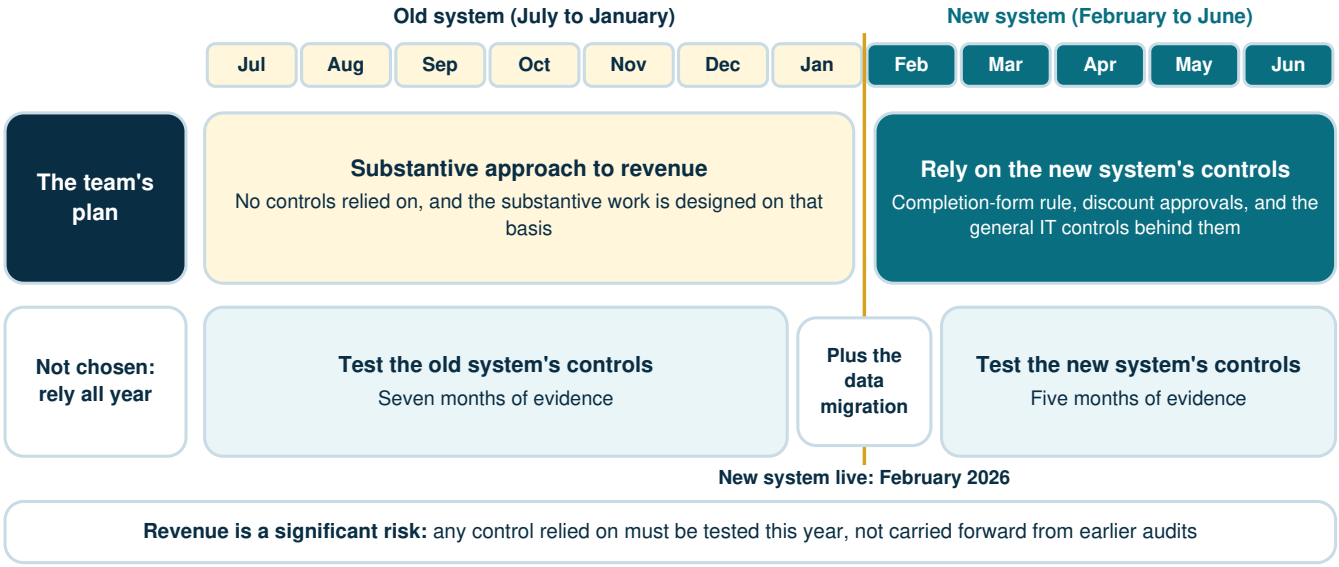
Automated, general IT and indirect controls

- **Automated controls.** Voltana's system won't recognise revenue until a customer-signed installation completion form has been submitted and matched to the contract. Software applies a rule the same way every time, so a few well-chosen examples can test it, as long as the program wasn't changed without authority during the period.
- **General IT controls come first.** Change management and access controls are what let the auditor say that a control tested once kept working all year. If they are weak, the automated control must be tested more directly, or the auditor relies on substantive work instead.
- **Indirect controls.** A manager's monthly review of a sales report is only as good as the report. The auditor also tests the accuracy and completeness of the report the manager used.

Timing and evidence from earlier audits

Situation	What the auditor needs
Controls tested at an interim date	Evidence about any significant changes to those controls since the interim date, then a decision on what more the remaining months need: for example, extend the tests to that period, or test how the entity monitors its controls
A control tested in an earlier audit, unchanged since	May rely on that evidence after confirming nothing has changed, but must retest each such control at least once in every three audits, and test some controls in every audit
A control that has changed since it was last tested	Test it in the current audit
A control over a significant risk	Always test it in the current period: earlier years' evidence can't be used

Voltana's plan across the system change



A sensible trade-off. Relying on controls for the whole year would mean testing the old system for seven months, the new one for five, and the migration between them, all in this year's audit because revenue is a significant risk. The team relies only on the new system from February, and designs the July to January substantive work on the basis that no controls were relied on for that part of the year.

When a test finds deviations

The team tests sixty discounts above 10% for evidence of a manager's electronic approval and finds two approved only after the sale had been recorded. The auditor then:

- makes specific enquiries to understand each deviation and its cause;
- considers whether it was a one-off error or a sign of something more, such as deliberate override: two late approvals by the same manager, both on large June sales, tell a different story from two random slips;
- decides whether the tests still give an appropriate basis for reliance, whether more tests of controls are needed, or whether the risk must be met with more substantive procedures instead.

Practice questions

MODULE 3 | 3.2.1 | TRY THESE BEFORE THE WORKED ANSWERS

Question 1 - Design and implementation, or operating effectiveness?

Keelson Forwarding Pty Ltd (imagined) arranges sea and air freight and customs clearance for importers. Its year ends on 30 June. Say whether each procedure tests design and implementation or operating effectiveness.

Procedure	Design and implementation, or operating effectiveness?
(a) Follow one shipment through the system, from booking to invoice, noting each control along the way	
(b) Inspect the finance manager's electronic approval, and its date, on 25 credit notes above $2,000 chosen from across the year	
(c) Ask the credit controller how she deals with customers who go over their credit limit	
(d) Read the delegation of authority policy for approving credit notes	
(e) Redo the reconciliation of shipping lines' statements to the cost ledger for three months spread across the year	
(f) Watch, once, as two staff open the high-value cargo cage together, to see that the procedure is in place	
(g) For every change to the freight rate tables during the year, check the change log for approval and testing	
(h) For weekly exception reports chosen across the year, check that each item was investigated and cleared	

Question 2 - Design a test of controls

For each of Keelson's controls, choose the best combination of procedures to test whether it operated effectively throughout the year.

Control at Keelson	Your test of controls (combination of procedures)
(1) The job system won't let an invoice be raised until a proof of delivery has been saved to the job	
(2) Each month an accounts officer reconciles every shipping line's statement to the cost ledger; the finance manager reviews and signs each reconciliation	
(3) Two staff must be present whenever the locked high-value cargo cage is opened	
(4) Credit notes above $2,000 need the finance manager's electronic approval before they are issued	

Question 3 - A payroll system changed mid-year

Until 31 December, Keelson ran payroll on an old in-house system. From 1 January it uses a payroll service rented from a cloud provider; employee details, pay rates and leave balances were migrated in December. Payroll is not a significant risk, and last year the team tested the old system's payroll controls and found them effective. The team would like to rely on payroll controls this year. Plan the testing of controls.

Worked answers

MODULE 3 | 3.2.1 | WORKED ANSWERS - ATTEMPT THE QUESTIONS FIRST

Question 1 - Keelson Forwarding

	Tests	Why
(a)	Design and implementation	A walkthrough of one transaction shows the controls exist and how they work
(b)	Operating effectiveness	Evidence of approval across the year, including whether it came before issue
(c)	Design and implementation	Enquiry helps understanding, but alone it can't show the control operated
(d)	Design and implementation	A policy shows what should happen, not what did
(e)	Operating effectiveness	Reperformance at different times during the year
(f)	Design and implementation	One observation shows the control is in place on that day only
(g)	Operating effectiveness	A general IT control tested for the whole period
(h)	Operating effectiveness	Follow-up of exceptions at different times during the year

Question 2 - Keelson's controls (suggested)

Control	Test of controls
(1) Proof of delivery before invoicing (automated)	Inspect the system setting and try the rule with one job that has a proof of delivery and one that hasn't (in a test copy); test the general IT controls over changes and access, so one test covers the year
(2) Monthly shipping line reconciliations	Enquire; inspect a sample of months for preparation, sign-off and timely follow-up of reconciling items; reperform one or two reconciliations in full
(3) Two staff at the cargo cage	Enquire; observe on several unannounced visits; inspect any access log or camera record of who entered
(4) Approval of credit notes above $2,000	Inspect approvals for a sample chosen across the year, checking the approval came before issue and was by the right person; or use data analytics to test every credit note above $2,000 for an approval dated before issue

Question 3 - Keelson's payroll (sample answer)

- **Two systems, two sets of evidence.** Reliance for the whole year needs evidence about the old system (July to December), the new one (January to June) and the migration between them.
- **Old system.** Payroll isn't a significant risk and the controls didn't change before the switch, so last year's evidence may be used once enquiry plus observation or inspection confirms nothing changed, provided each control is retested at least every third audit and some controls are tested this year.
- **Migration.** Test the conversion controls: reconciliations of employee numbers, pay rates and leave balances between the systems, reviewed and signed off. If they are weak, test the migrated data directly.
- **New system.** No earlier evidence exists, so test in the current period: obtain the cloud provider's assurance report on its controls over the period (check dates and exceptions), and test Keelson's own controls, such as approving new employees and pay rate changes and reviewing each pay run.
- **The alternative:** rely on the new system only and take a substantive approach for July to December, for example an analytical procedure built from headcount and pay rates.