

Sarbanes-Oxley Act

Section 404 Internal Control Testing Guidelines

Why do we have to test controls if we have already documented their existence?

Testing of internal controls allows a company to assert that controls are operational. This process of testing should be based on a test plan that incorporates guidance issued by the SEC, PCAOB and your external auditor. A company should also look at testing as an opportunity to evaluate their operations and test the high risk areas identified during their SOX 404 documentation project.

How do we get started?

The first step in testing is to create a test plan, the list of controls you are going to test and method you will use for testing. The test plan should be designed to test an adequate number of controls to ensure you can make all relevant financial assertions related to your significant financial accounts. The significant accounts are identified in the initial 404 project scoping and the controls are identified in the documentation phase of the project. The review and evaluation phase of your control documentation should be conducted so you can identify the “key” or most important controls that ensure your financial statements are complete, accurate and not misleading. These are the controls that will allow you to make the assertions for your significant financial accounts.

The test plan should include a timeline, details on who, what, when, where and how the testing will be conducted and the actual testing instructions or test scripts. The number and complexity of these test scripts will be determined by the size and complexity of your business.

It is important to complete the documentation and evaluation phase of your Sarbanes Oxley 404 Internal Controls project prior to starting your testing. However, it is possible, and sometimes necessary to begin testing some controls before all documentation is completed. In many cases you may find control design deficiencies within a business process or business cycle that need to be remediated.

What are the requirements?

Guidance indicates that a company must perform equal to or greater than the testing that is performed by their external auditors. This guidance includes both the number of controls tested and the size of the samples tested. In addition, testing should be conducted within a reasonable period of time prior to the last day of the fiscal year. The PCAOB defines this period as 180 – 90 days prior to date of assertion. In addition, guidance suggests that in order to ensure the operation of controls as of the year end date, any testing conducted prior to 90 days of last day of the year, should be rolled forward. This roll forward should be conducted in a manner that provides evidence that the controls are still operational.

In order to perform testing to allow remediation it is suggested that testing be performed in at least 2 cycles. A cost effective approach is to conduct INTERIM testing based on sample sizes below after the 2nd quarter has closed for all except Annual controls and YEAR END testing within 90 days of the year end. The year end sample sizes for controls tested during INTERIM testing can be reduced and the actual sample size will vary based on the nature of the control and frequency.

How large of a sample is required?

The following table summarizes testing guidance for testing a specific control in situations where a company is testing MORE THAN ONE CONTROL related to a significant assertion for a significant account where they DO NOT EXPECT TO FIND EXCEPTIONS in the operation of the control:

Nature of Control and Frequency of Performance	Minimum Number of Items to Test (Extent of Test of Controls)
Manual control, performed many times per day	At least 25
Manual control, performed daily*	At least 25
Manual control, performed weekly	At least 5
Manual control, performed monthly	At least 2
Manual control, performed quarterly	At least 2
Manual control, performed annually	Test annually
Programmed control	Test one application of each programmed control for each type of transaction if supported by effective IT general controls that have been tested); otherwise test at least 25
IT general controls	Follow guidance above for manual and programmed aspects of IT general controls

* Some controls might be performed frequently, but less than daily. For such controls, the sample size should be interpolated using the above guidance. Generally, for controls where the number of occurrences ranges from 50 to 250 during the year, our minimum sample size using the above table should be approximately 10% of the number of occurrences.

When testing a single control for an assertion OR if you expect to find an exception, increase the sample size as follows:

- **Daily** = 40 with one exception allowed – if more than 1 but less than 3, pick a new sample
- **Monthly** = 3 no exceptions – if there is an exception, pick a new sample
- **Quarterly** = 3 no exceptions – if there is an exception, pick a new sample

What if there is an exception found during testing?

Each exception should be researched and findings documented. The findings should be evaluated to determine why the control failed and remediation actions should be initiated. This documentation should note if the test failed due to a design or operational deficiency and the gap should be logged with all other gaps and remediation actions should be assigned and tracked.

Controls should be retested upon completion of the remediation and after a sufficient population is available to test.

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