

Control Environment

Control environment, an intangible factor and the first of the five components, is the foundation for all other components of internal control, providing discipline and structure and encompassing both technical competence and ethical commitment.

Managers must evaluate the internal control environment in their own unit and departments as the first step in the process of analyzing internal controls. Many factors determine the control environment and are listed below for consideration. This list is not all-inclusive, nor will every item apply to a particular unit.

“Integrity and Ethical Values”¹

- Existence and implementation of codes of conduct and other policies regarding acceptable business practice, conflicts of interest, or expected standards of ethical and moral behavior.
- Dealings with employees, suppliers, customers, investors, creditors, insurers, competitors, and auditors, etc. (e.g., whether management conducts business on a high ethical plane, and insists that others do so, or pays little attention to ethical issues.)
- Pressure to meet unrealistic performance targets-particularly for short term results-and extent to which compensation is based on achieving those performance targets.

Commitment to Competence

- Formal or informal job descriptions or other means of defining tasks that comprise particular jobs.
- Analyses of the knowledge and skills needed to perform jobs adequately.

Board of Directors or Audit Committee

- Independence from management, such that necessary, even if difficult and probing, questions are raised.
- Frequency and timeliness with which meetings are held with chief financial and/or accounting officers, internal auditors and external auditors.
- Sufficiency and timeliness with which information is provided to board or committee members, to allow monitoring of management’s objectives and strategies, the entity’s financial position and operating results, and terms of significant agreements.
- Sufficiency and timeliness with which the board or audit committee is apprised of sensitive information, investigations and improper acts (e.g., travel expenses of senior officers, significant litigation, investigations of regulatory agencies, defalcations, embezzlement or misuse of corporate assets, violations of insider trading rules, political payments, illegal payments).

Management's Philosophy and Operating Style

- Nature of business risks accepted, e.g., whether management often enters into particularly high-risk ventures, or is extremely conservative in accepting risks.
- Frequency of interaction between senior management and operating management, particularly when operating from geographically removed locations.
- Attitudes and actions toward financial reporting, including disputes over application of accounting treatments (e.g., selection of conservative versus liberal accounting policies; whether accounting principles have been misapplied, important financial information not disclosed, or records manipulated or falsified).

Organization Structure

- Appropriateness of the entity's organizational structure, and its ability to provide the necessary information flow to manage its activities.
- Adequacy of definition of key manager's responsibilities, and their understanding of these responsibilities.
- Adequacy of knowledge and experience of key managers in light of responsibilities.

Assignment of Authority and Responsibility

- Assignment of responsibility and delegation of authority to deal with organizational goals and objectives, operating functions and regulatory requirements, including responsibility for information systems and authorizations for changes.
- Appropriateness of control-related standards and procedures, including employee job descriptions.
- Appropriate numbers of people, particularly with respect to data processing and accounting functions, with the requisite skill levels relative to the size of the entity and nature and complexity of activities and systems.

Human Resource Policies and Practices

- Extent to which policies and procedures for hiring, training, promoting and compensating employees are in place.
- Appropriateness of remedial action taken in response to departures from approved policies and procedures.
- Adequacy of employee background checks, particularly with regard to prior actions or activities considered to be unacceptable by the entity.
- Adequacy of employee retention and promotion criteria and information-gathering techniques (e.g., performance evaluations) and relation to the code of conduct or other behavioral guidelines.”

As you may have surmised from reading the previous list, there are three main focuses to evaluating the control environment.

First, management's attitude, actions and values set the tone of an organization, influencing the control consciousness of its people. Internal controls are likely to function well if management believes that those controls are important and communicates that view to employees at all levels. Conversely, if management believes that controls are unrelated to achieving objectives or are obstacles then this attitude will be communicated. Management can show a positive attitude toward internal control by such actions as including internal control in performance evaluations, discussing internal controls at management and staff meetings, and by rewarding employees for good internal control practices.

Second, commitment to competence includes a commitment to hire, train, and retain qualified staff. It encompasses both technical competence and ethical commitment. Management's commitment to competence includes both hiring staff with the necessary skills and knowledge and ensuring that current staff receives adequate on-going training and supervision.

Third, the involvement of the Audit Committee of the Board of Directors in a review of internal controls and audit activities can be a positive influence on the organization's control environment.

¹ Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Integrated Control – Integrated Framework*, (New Jersey: American Institute of Certified Public Accountants, 1994 edition), pg. 31-32.