Prior to the corporate difficulties of Enron, WorldCom, Tyco and other large organizations, the phrase “control environment” was not something that came up in corporate settings or Board discussions very often. Sarbanes-Oxley escalated the importance of the concept and the awareness of its implications on the interworkings of companies. Internal and external auditors began focusing on ways to evaluate the true meaning of control environment and experimenting with methods to effectively measure the existence of a proper control environment within their own corporate settings.
We all know the phrases “tone at the top”, “management philosophy and operating style”, but we continually have difficulties finding ways to accurately measure those attributes. Complicating that aspect is the political implications and associations of attempting to communicate to management that their control environment may not be as effective and adequate as they believe. Have you ever tried to tell management that elements of their control environment may have design flaws or gaps that could result in unwanted behavior? If so, what was the response you received from management and or the Board?

The control environment has a pervasive structure and impacts many business process activities. It includes elements such as management’s integrity and ethical values, operating philosophy and commitment and tone at the top. The control environment is an integral part of the internal control system and therefore must be understood, evaluated and tested, first by management, and then by the external auditors. Anyone who has ever been involved in assessing the control environment of an organization will tell you it is easy to say but hard to do.

The subjective, non-transaction-oriented nature of the control environment creates many challenges. Sarbanes-Oxley requires evaluation of the control environment. Just because it may be a difficult thing to measure does not provide management with adequate rationale for noncompliance.

During our webinar on the control environment I correlated the difficulties using the following example. Take a look at the adorable picture below.

Now think:
“Control Environment, what’s the big deal? Could we possibly do anything you wouldn’t want us to? Look at our faces?

Ok, you might think…..come on now, this is quite a stretch. Well, not really. Those cute little puppies were born to my golden retriever on Superbowl Sunday. A litter of nine adorable little pups, what could be more adorable? In their first five weeks of life, their mother instinctively took close care over her babies, making sure they were fed and cleaned. But as the little pups started to learn to walk around and became a bit more active, momma backed off and the requirements of feeding and cleaning up after them became quite overwhelming. In other words, the control environment shifted pretty quickly and dramatically. Within a few weeks, those adorable nine puppies became very active little rascals. Mom decided it was no longer her role to always be around and clean up after their messes. We went from watching this adorable litter of pups stay close to their mom to trying to figure out how to keep them contained within their whelping box while cleaning up after them and making sure mom was around when they got hungry. It was quite a job and frankly not one I was ready for.

I use this as an analogy because there are many similarities to what happens in our day to day business environment. Organizations start out by setting policies and processes to follow. In early days, those policies and processes may work effectively and possibly don’t require a lot of monitoring. But as the organization grows and changes, as people come and go, as the strategy of the organization shifts, those policies and processes that were established may not necessarily be as effective as they once were. The dynamics have changed, people have changed, the organization has grown or adjusted so logically, the control environment has probably changed. The organization must adjust its methods to ensure the intentions and strategies are effectively met. But does this happen? How often do we see organization try to “get by” with the methods they have previously used and justify it with “nothing has happened so why should we change anything?”

Rather than reciting all the various attributes of the control environment that should be assessed, let’s focus on the difficulties of an assessment and possible ways to overcome those difficulties. Of course, each item covered won’t necessarily work in every organization so it is incumbent upon each organization to continually reassess its specific capabilities and be open to sugges-
To adequately assess the control environment, you must be able to assess the tone at the top. In most cases, individuals are evaluating the control environment of the whole organization so tone at the top is interpreted to be tone as it relates to senior management and the board. We can all easily see how any type of assessment of tone at the top for this level can create challenges. So it is easy to understand why assessments that relate to “tone at the top”, may not provide sufficient insight into issues that should be further evaluated or may need to be addressed. If the assessment is being done by an internal group like compliance or internal audit, trying to adequately communicate to the CEO and Board that certain items may not be “setting the right tone” can be viewed as a pink slip waiting to be handed out. Yet, somehow we need to get past the simple check the box evaluation methods that look to see if certain things exists like board charters, code of conducts, conflicts of interest, authorization policies, personnel evaluations etc. These things are only as good as the focus to ensure they have quality aspects imbedded and that they do not just exist because of some compliance requirement. Management must understand and buy-into the concept that tone at the top means that management fully supports that procedures and evaluations are accepted and recommendations are readily evaluated for their potential impact to control environment processes. Here is an example:

Company ABC has a written authorization policy that applies to procurement professionals. On the surface, this process appears to contribute to a strong control environment. But now let us assume a few more “qualitative” characteristics. What if the authorization policy does not cover some strategic areas such as contract approvals, management overrides etc. Also assume that the policy was created strictly by the finance organization without input from the remainder of the organization. Further assume that the company does not have any monitoring methods in place to identify when authorization procedures are not being followed. All of these assumptions taken into aggregate could obviously create issues with the control environment. In addition, even one of these attributes could result in a design gap that may impact the organizations control environment in a manner that is unacceptable to management. So now we have a dilemma.

How does the evaluator communicate to management the potential risk to the organization of these control gaps? Or, what if you communicate the issues, management agrees but comes to the conclusion that the gaps are not of significant concerns because no issue has come to light regarding unauthorized payments being made. If an issue has not yet “come to light” or been identified, does that minimize the finding? What if the evaluator’s opinion on how the identified gaps impact the control environment differs with management? An obvious step may be to speak to the board or the audit committee. A challenge may be related to the relationships established/not established with members of the board by the various parties involved. If management has a more direct communication link and the evaluator does not, is the assessment criterion being communicated on an independent basis?

If you are waiting for a textbook answer to the above dilemma, you may be disappointed. All organizations are different, all relationships are different, all perceptions and evaluations are different so the steps to take in resolving the above dilemmas could all be different. The important criterion here are:

• The evaluator should have full authority to analyze the situation beyond just the existence of policies.
• The ability to communicate missing qualitative concepts is extremely important in bringing to light control environment issues.
• Management must be able to understand the difference between a control gap and a control failure. Yes, it is important to know if the gap has created a failure but just because it hasn’t to-date, does that minimize the potential impact of the gap on the control environment?
• Organizations need to ensure that when they are assigning evaluators the responsibility of analyzing the effectiveness of these attributes, they understand the methods that may be employed and are open to the issues that may be identified.
• Last, independent communication with senior management and the board is essential. If there is a disagreement related to severity of the issue as perceived by management vs. the evaluator, the
Board should have the ability to independently hear the view of both sides of the issues and not be influenced by the opinion of one side or the other.

Management Philosophy and Operating Style

Let’s take another separate example related to quarterly attestations by management related to the control environment and internal controls. Most publicly traded companies have procedures in place for sign-off of internal control processes for Sarbanes-Oxley 302 procedures. Organizations have established elaborate procedures to provide assurance to their CEOs and CFOs prior to final attestation within the SEC filings. These procedures involve requiring heads of major business units and or subsidiaries to provide personal attestations on controls related to their area of responsibility. So it is a strong control environment procedure to require quarterly attestations by the heads of major business units or subsidiaries.

Now let’s assume that the procedure utilized to obtain those quarterly attestations was established back in 2004, the first year of Sarbanes-Oxley compliance. The procedure is a signature from each of the business unit leads that indicates “To the best of my knowledge, internal control procedures within my area of responsibility as well as financial information provided to management is accurate and complete”. Those procedures were originally accompanied by specific training for the business unit leads related to Sarbanes-Oxley requirements. Now, several years later, many of the personnel who are signing the attestations are individuals who have been promoted or moved into the position but there hasn’t been any specific dedicated training to what the attestation means. They look at the process as a “step” they must complete each quarter because management requires it. As an independent evaluator, what would your assessment of the effectiveness and adequacy of this procedure be? Do you believe management understands what they are attesting to? Also, since the attestation is just a simple signature, do you think management would inherently know what types of control issues should be brought to management’s attention? If you have questions related to these inquiries, would you be able to tell management that the current control environment is working appropriately?

And, if you relayed your control environment concerns to management, what would their response be?

Inherently, management probably believes they have a procedure in place, they are requiring appropriate personnel to sign the attestation, and so everything should be fine, right? On the surface, that would be a logical assumption but if management truly is looking for proper control procedures, they must be able to understand the potential ramifications of some of the qualitative control gaps identified. If they cannot, if the control gaps are not addressed, the gaps could lead to deficiencies and control environment issues that are unacceptable to management.

So where is the textbook answer on this item? A suggestion would be to point back to the requirements of Sarbanes-Oxley and the associated liabilities to management if attestations are not adequately obtained. Outlining to the CEO and CFO what their potential liabilities are related to relying on attestations of their management that may not be fully accurate may be sufficient to convince them that it is important to ensure any attestations are obtained through full understanding and disclosure.

Segregation of Duties

This can be an extremely difficult area to adequately assess and evaluate. Segregation of duties is the concept of having more than one person required to complete a task. The intent is to ensure proper authorization, avoidance of error and prevention of fraud. General categories of functions to be separated:

- Authorization function
- Recording function,
- Custody of asset whether directly or indirectly, e.g. receiving checks in mail or implementing source code or database changes.
- Reconciliation or audit

The reason segregation of duties is an important part of the control environment is because it involves how, when and where job tasks related to everything from financial reporting to operating activities is executed. It is critical that appropriate segregation responsibilities be in place to minimize risk to the organization as well as protect individual employees from false allegations of wrongdoing.
The most prevalent times of segregation of duty issues often occur in smaller organizations or where personnel sourcing is limited. In these cases, it is often very difficult for management to understand how and when segregation should be applied to various responsibilities.

As managers and executives, we believe we perform our due diligence to hire honest and trustworthy personnel. So in times of resource constraint, we may sometimes place overreliance on critical personnel to perform duties that may put both the organization and the individual employee at risk. In these situations, the control environment is also put at risk. Regardless of size of operation and availability of resources, organizations must do everything in their power to ensure appropriate checks and balances are in place for critical financial and operational activities. A strong control environment can only be supported through appropriate segregation of responsibilities and assignment of duties. If the resources are not available to provide appropriate segregations, then management must assess the risk imbedded in the processes and identify ways to appropriately monitor transactions and activity. In the end, the lack of appropriate segregation of duties will place liability on the CEO, CFO and company board.

Overview

A company’s control environment should be considered as the very foundation upon which the company can effectively execute on its strategy. Gaps or flaws in the control environment must be fully assessed and regularly evaluated to provide adequate assurance regarding the sufficiency of controls. If management focuses only on the activities related to “check the box” for control environment attributes, they will miss some critical attributes that may result in major breaks that ultimately impact the viability of the organization.