Understanding one of the internal control components – the control environment

(Relevant to AAT Examination Paper 8 -- Principles of Auditing and Management Information Systems)

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Introduction

Internal control is one of the more frequently examined topics in Paper 8: Principles of Auditing and Management Systems (see June 2009, Question C2, June 2010, Question C2 and June 2011 Question C3). However, the examiner's reports often show that candidates are not familiar with key issues in internal control. Internal control covers a wide range of knowledge, including internal control components, control procedures, control systems, risk assessment, etc.

This article aims to assist students to grasp an in-depth understanding of the following:

(a) What internal control is and what its components are
(b) The control environment, including the identification of its strengths and weaknesses.

Internal control

Internal control is defined as the **process** designed, implemented and maintained by **those charged with governance, management and other personnel,** to provide **reasonable assurance** about the achievement of an entity's **objectives** with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the **components of internal control**.

(Source: Glossary of Terms Relating to Hong Kong Standards on Quality Control, Auditing Review, Other Assurance and Related Services)

A few key points can be learned from this official definition about the what, who and why of internal controls and their major components.

What is an internal control? An internal control is a process, which means that there is a series of actions taken, and policies, procedures and methods implemented in a company. It is internal, so it is related to a particular company and the specific policies and procedures in the company. Internal controls are accomplished by management establishing an effective **internal control system**.

Who designs internal controls? Not only management, but also those charged with governance and other personnel who will carry out the internal control procedures. It is the primary responsibility of management to set up and maintain an effective internal control system to achieve their objectives.

Why is reasonable assurance an essential element in internal controls? Reasonable assurance is less than absolute assurance but more than a low level of assurance. Management has some acceptable uncertainties about the effectiveness of internal controls. This implies that internal controls are not perfect or have some inherent limitations, e.g. human errors, management override, collusion between personnel, cost and benefits and inadequacies in dealing with changes in conditions such as environmental protection regulations.

Management has three objectives in establishing internal controls:
1) Reliability of financial reporting
2) Effectiveness and efficiency of operations
3) Compliance with applicable laws and regulations

Auditors are primarily concerned with internal controls that achieve the first objective because the objective of a financial statement audit is to give an opinion on whether the financial statements give a true and fair view. It is important for auditors to understand these controls and assess the control risk so as to determine the nature, timing and extent of audit testing. (See HKSA 315 “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment”)

The major components of an internal control system include:
1) The control environment
2) The company’s risk assessment process
3) Control activities
4) The information system (including the relevant business processes), relevant to financial reporting and communication
5) Monitoring of controls

The control environment
The <u>essential elements</u> of the control environment are described in HKSA 315 “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment” and are thoroughly explained in AAT Paper 8 Study Text, “Principles of Auditing and Management Information Systems***”,*** Teresa M. H. Ho, Lisa S.K. Wong, Pearson, 2011, chapter 6, pp. 136-137, as follows.

The control environment **embraces** the other four components of the internal control system because it sets the **tone** of an organization and influences the **consciousness** of its people. It is the **foundation** for effective internal controls, providing discipline and structure.

The control environment refers to the overall **attitude, awareness and actions** of management regarding internal controls and their importance. This is referred to the **triple A** of management. These as, in turn, are illustrated by the following seven elements, with strengths and weaknesses identified by auditor. (Strengths indicate the auditor’s assessment as a strong control environment, whereas weaknesses denote a weak control environment.)

Seven elements of the control environment
1. <u>Communication and enforcement of integrity and ethical values</u> – management’s

actions in communicating the organization's ethical standards to its employees. This involves management actions to remove any incentive or temptation that may induce employees to engage in dishonest, illegal or unethical acts. The communication of company policies on integrity and ethical values includes the communication of behavioural standards to employees through policy statements, codes of conduct, etc.
Strengths: There is a code of ethical conduct (except in the case of small companies in which the manager closely monitors operations), and management has high integrity.
Weaknesses: Management suffers from a poor reputation due to a lack of integrity.

2. Commitment to competence – management's consideration of the competence levels for particular jobs. The commitment is reflected in the consideration of how to translate those levels into requisite knowledge and skills.
Strengths: Management hires competent staff who possess the knowledge and skills needed to perform the job duties.
Weaknesses: Management employs incompetent or inexperienced staff for senior or inappropriate positions.

3. Participation by those charged with governance – a company's control consciousness is significantly influenced by those charged with governance (board of directors and/or audit committee.) However, the effectiveness of those charged with governance depends on their level of independence and experience and the extent of their scrutiny over activities. The status and recognition of governance bodies is also important.
Strengths: There is an active board of directors with an audit committee taking the highest level of responsibilities charged with governance. Members of the audit committee are independent non-executive directors.
Weaknesses: A company does not have an internal audit department

4. Management's philosophy and operating style – management's awareness of and response to risks, financial reporting, information processing, accounting functions and personnel.
Strengths: A conservative management will more likely be prudent in preparing the financial reports, thus enhancing the truth and fairness of the financial statements.
Weaknesses: An aggressive (risk-taking) management attitude will tend to achieve window dressing and manipulation of profits by selecting inappropriate accounting principle.

5. Organizational structure – establishes key areas of authority and responsibility and sets appropriate lines of reporting. This is a framework within which a company's activities needed to achieve its objectives are planned, executed, controlled and monitored.
Strengths: A client in a high-technology industry operates an agile organizational structure.
Weaknesses: A company's divisions may operate as autonomous units with little monitoring

6. Assignment of authority and responsibility – formal communication of authority and responsibility and making these clearly known to all personnel. This can be done through formal organizational and operating plans and employee job descriptions.
   Strengths: Clear job descriptions are provided.
   Weaknesses: There is a lack of policies and communication about job responsibilities among personnel.

7. Human resources policies and practices – human resource policies and practices demonstrate important matters in relation to the control consciousness, for example, a company's policies and practices of recruiting the most qualified individuals, training, evaluating, promoting and compensating employees.
   Strengths: A company has sound human resources policies.
   Weaknesses: Inadequate human resources policies lead to incompetent people being hired to fit incompatible positions, inefficiencies in task accomplishment and errors in the provision of information, etc.

Conclusion

The internal control system includes all the policies and procedures established by management to achieve three objectives: reliability of the financial reports, operating efficiency and effectiveness, and compliance with laws and regulations. There are five components of internal control, one of which is the control environment. The control environment is the foundation for effective internal control and is about the attitude, awareness and actions (the triple A) of management towards internal controls. The triple A is reflected by seven elements. When evaluating strengths and weaknesses in the control environment, auditors assess the seven elements. The rating is either strong or weak. For example, an honest, conservative management, independent corporate governance with active participation of board of directors, sound human resources policies and suitable organizational structure are all conclusive indicators of a strong control environment.