Public Internal Control Systems in the European Union

Towards an optimal Internal Control Environment

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Towards an optimal Internal Control Environment

The foundation of an effective internal control system which ensures that operations produce the intended outputs largely depends on a solid control environment. In most organisations, the crucial 'hardware' related to the Internal Control environment, i.e. codes of conduct and appropriate policies and procedures are usually in place. But that hardware is not sufficient on its own: the challenge remains of how to influence human behaviour and attitudes to create an organisation-wide ‘attitude of sound integrity and control consciousness’, and how to set a favourable ‘tone at the top’.

The purpose of this paper is to tackle the interaction between those formal structures and the behavioural aspects that are required to create, improve and maintain a solid control environment. To that end, a series of practical tools and examples that can be labelled as good practice are suggested throughout this paper.
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1. **INTRODUCTION**

The control environment, as part of the internal control framework, is the foundation for carrying out effective controls across the organisation. Although all stakeholders in any organisation, whether public or private, would no doubt agree that the appropriate control environment is paramount, practice shows that it not easy to manage. It therefore does not always get the attention it deserves. Formal structures and procedures such as a code of ethics, HR procedures, accountability arrangements, delegation structures etc. are mostly well documented (although their regular updating is often neglected) but to ensure that they are well implemented and accepted by all stakeholders, from top management to the work floor, is a continuing challenge. Indeed keeping them **alive (i.e. dynamic and applied as intended)** throughout the organisation is an ongoing concern/permanent task.

The control environment consists of two sides: formal structures and aspects of individual behaviour; and they both need to interact. Levels of compliance with codes and procedures are affected by human behaviour, by the personal moral consciousness and awareness of management and staff, and by their attitudes and perceptions. This paper aims to address these different aspects, insights and skills to create support and a positive attitude towards the organisation’s procedures, values and objectives. It will particularly focus on **the interaction between human behaviour and the organisation’s functioning**.

Management has the key role in endorsing and supporting the control environment, not only by words but also by deeds (‘say what you do and do what you say’). In this paper practical examples and tools are provided to help management promote and stimulate a solid internal control environment. Clearly this cannot be an exhaustive list; but discussions during the Conference Workshop should augment it, based on real examples and good practices.

2. **CONTROL ENVIRONMENT AND ITS COMPONENTS**

COSO\(^1\), defines the control environment as follows:

> ‘It sets the tone of an organisation, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility, and organises and develops its people; and the attention and direction provided by the board of directors.’

In essence, the IIA definition is similar\(^2\):

> ‘The attitude and actions of the board and management regarding the importance of control within the organisation. The control environment provides the discipline and structure for the achievement of the primary objectives of the system of internal control. The control environment includes the following elements:

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\(^1\) The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a joint initiative of five private sector organizations (AA, AICPA, FEI, IIA and IMA) and is dedicated to providing thought leadership through the development of frameworks and guidance on enterprise risk management, internal control and fraud deterrence.

\(^2\) IPPF Glossary etc.
• Integrity and ethical values.
• Management’s philosophy and operating style.
• Organizational structure.
• Assignment of authority and responsibility.
• Human resource policies and practices.
• Competence of personnel.

The internal control environment includes formal structural and 'soft' behavioural aspects. People and organisations need each other and the manner in which they interact is crucial to the success of the organisation. Attention should therefore be focused on improving the people-organisation relationship. To establish and maintain this bond, interaction needs to take place at different levels.

The initial starting point is that the organisation should establish a formal (written) framework with clear governance structures underpinned by unambiguous, outspoken values and procedures. But having written instructions, procedures and manuals is not enough, they need to be followed through. The framework needs to be understood, accepted and adhered to at all levels of the organisation, by management and staff alike. Therefore the more informal, behavioural dimensions need also to be addressed; these concern values, beliefs, attitudes and the conduct of people.

If the internal control framework within an organisation does not deliver the expected results, the root causes could vary, but often the control environment is one of them. If the control environment is sub-optimal, this will have negative effects on the other components of the internal control framework and hence to the organisation in its entirety. Every component of the internal control system depends not just on how processes and procedures are established but on how they are executed by people.

3. LEVERS TO DEVELOP AN OPTIMAL CONTROL ENVIRONMENT

The design and establishment of a solid control environment is clearly a management responsibility. However, to make it work in practice, everyone in the organisation needs to be involved: senior and middle management as well as staff. Managing the control environment involves ensuring the organisation’s ethical values, and the processes and procedures underpinning those values are communicated, maintained and enforced throughout the organisation. However, systems and structures provide no guarantee that people will do the right thing. Adherence to policies and ethical codes depends on humans, their perceptions, attitudes and behaviour. So the management of the organisation has to stimulate people to understand and accept its corporate values and procedures. Enhancing the control environment also means management needs to measure, monitor, and in case of undesired conduct by staff, act and be known to have acted. Managing the control environment should not be reactive and ad hoc but should be a part of planning, execution of daily business, and the evaluation and monitoring process. Internal auditors being 'key agents of change' in the organisation should assess the control environment and inspire and motivate management to act if necessary.

3 Muel Kaptein ‘The Servant of the People: on the power of integrity in politics and government.’ September, 2014
3.1. Organisational values, and supporting structures and procedures

**Clear values supported by coherence in processes and procedures** throughout the organisation are essential. As it spends taxpayer’s money, a public-sector organisation must have procedures in place allowing it to demonstrate the manner in which those resources were used and the results achieved. These accountability structures should reflect the ethical climate of the organisation.

3.1.1. **Clarity and coherence of values, processes and procedures throughout the organisation**

The values and mission of the organisation should be explicitly and clearly stated. A code of conduct is a good instrument for setting out an organisation’s values and ethical obligations and for determining what is expected from management and staff behaviour. Its value lies not only in its finished content, but also in the process it represents. A broad approach capturing the expectations of all stakeholders is crucial. The code should reflect the results of discussions which have captured input from everyone in the organisation. The stated values should be unambiguous and reflected in operational and individual objectives. In the public sector, values are often very broadly defined in terms of objectivity, honesty, sustainability etc. However, management and staff may not always be able to interpret what these abstract principles mean for their behaviour in a given situation. Therefore objectives on every level (from strategic to operational and even individual levels) should reflect and refer to the organisation’s values and mission, to explain and clarify the content and meaning of those values. The same applies to all other procedures and processes, especially those which have a direct influence on the control environment, such as Human Resources.

Just putting a code of conduct in place is not enough unless it is understood by all. Often codes are too abstract to be useful in real life, particularly when things get rough or when people have to work under tight deadlines or must produce outputs. Nevertheless, management has the primary responsibility for ensuring that all those who work for, or supply, the organisation, have a solid understanding of the ethical climate that the organisation subscribes to and maintains.

**Concrete tools and instruments:**

- All management plans, regardless of level, should reflect the organisation’s values and ethics
- Requiring an individual ‘ethical contract’ or code of conduct to be signed between recruiter and recruit at the moment of first entry into service and periodical (e.g. annual) re-signing
- Dilemma training during which the organisation’s values are explained in very concrete situations (for all levels of the organisation, including management)
- Training for staff explaining and clarifying values and expectations
- Workshops on ethics and values including some especially for senior and middle management
- HR procedures for hiring, evaluation and dismissal must reflect and openly support the organisation’s mission and values

- The organisation’s values are included in function profiles and job descriptions

- Ethical clauses in procurement processes and in contracts with external suppliers

- Ethics coordinators with specific responsibilities to promote and enhance awareness of ethics

- The key values of the organisation are publicly displayed

- Developing a process to report suspected violations of the organisation’s code of conduct

3.1.2. Accountability structures

A balanced structure of accountability, responsibility and authority (the ‘accountability triangle’) is essential\(^4\). Public organisations are responsible for managing public funds to deliver clearly defined results. Therefore, public sector entities are not only accountable for how much they spend, or how they use these resources (the classical objectives of an input-oriented organisation) but also whether the intended results have been achieved (output-oriented). Having reputational risk in mind, management and staff should adhere to values above the minimum legal requirements built on established principles for behaviour in public life. Public servants must act diligently, reflecting public expectations and strive for value in favour of public interest. The core values underlying good governance for all who work for a public entity can be enumerated as follows:\(^5\&\(^6\)

1. Legitimacy: respect the law at all times
2. Selflessness: act only in the public interest
3. Integrity: be straight in using public funds
4. Objectivity: choices made on merits only
5. Accountability: facilitate internal and external (public) scrutiny
6. Openness: give reasons for decisions taken
7. Honesty: when resolving conflicts of interest
8. Leadership: promote support for these principles

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\(^4\) See PIC Network Position Paper “Principles of PIC”
\(^5\) Sources: Lord Nolan 1995, Standards in Public Life, and
\(^6\) Quality of Public Administration, European Union, 2015
Concrete tools and instruments:

- Annual Management Declarations to be published
- Transparent administration, ‘sunshine’ laws
- Training and awareness campaigns focusing on bridging any gap between organisational objectives and the public interest, clarifying objectivity and the meaning of conflict of interest
- Declaration or statement of absence of conflict of interest to be signed for sensitive posts and/or activities
- Internal and external reporting to include ethical issues

### 3.2. Implementation on the 'individual level' of people

In most organisations, the formal structures which articulate its core values are in place but these can only be effective if they are understood and applied by all. Social and psychological studies show that human behaviour is influenced by drivers which help them identify themselves with others or their environment such as status, certainty, autonomy, relatedness and fairness. These drivers can be used by the organisation to encourage its members to act according to its core values, adhere to its procedures and policies and strive to achieve organisational objectives. A variety of aspects should therefore be considered to make people take on the organisation’s chosen values and to make them act accordingly.

The real challenge therefore is to ensure that these formal structures and guidelines are respected in daily operations; the key question is how to stimulate and motivate people to identify themselves with the core values of the organisation.

### 3.3. Creating awareness and involvement

Public entities have a particular responsibility toward citizens because of the nature of their resources - taxpayer's money. Therefore, how the organisation functions will also have an influence on public perception and can enhance (or not) the legitimacy of public organisations. Making public servants aware of their responsibility to uphold the reputation of the organisation may be achieved by matching individual interests with the organisation’s interests.

Involving staff in developing a vision and in the achievement of objectives by recognising their contribution can create motivation and enthusiasm. A collective vision supported by every level of the organisation will be perceived as a success for each team member.

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8 Sunshine laws are laws with ‘built-in’ provisions allowing for openness towards the public concerning activities and results.

Concrete tools and instruments:
- Linking an individual’s objectives to management plans
- Awareness campaigns or events on organisation’s mission and values
- Make reward systems (e.g. pay, promotion) coherent with the organisation’s objectives and values

3.3.1. Promoting ethics by taking up role model and tone-at the top

In all organisations, managers, at senior and middle levels alike, present important role models for their co-workers since they are expected to display the values and norms of the organisation. The way management acts and steers the organisation needs therefore to be consistent with the predefined corporate values. Individual staff behaviour can be influenced by their perception of the management’s 'ethics' when those staff are faced with difficult situations and decisions. Can we expect staff to act in accordance with the written instructions on travel and subsistence claims when they believe that (top) management abides by other rules?

If it is perceived that the rules do not apply to all, then a strong incentive is created for rationalised non-compliance, which should obviously be avoided. However, making (top) management aware of their responsibilities in this delicate area is a sensitive topic. Fortunately there are useful techniques which allow managers to take a critical look at the way they are operating.

Concrete tools and instruments:
- Testing ethical compliance during management selection procedures
- Seminars and awareness campaigns on ethics and values for management both collectively and individually
- Self-assessment tools for managers (evaluation questionnaire) including ethical aspects
- 360° evaluations for managers (with evaluations including ethical aspects)

3.3.2. Motivating staff

The way people are regarded and treated by management will have a crucial influence on the control environment. When people feel valued and respected by management, they will tend to commit to expectations and to anticipated results. This can be done by rewarding them financially but very often appreciation can be as effective a reward as money. Management should motivate people by focusing on talents and strengths, encouraging creativity and supporting new ideas. A good working environment and a supportive approach to good team spirit will also have positive effects on values and the willingness to achieve collective organisational objectives.
Concrete tools and instruments:

- Allowing staff to influence the mix of their talents and skills to be developed
- Providing a framework within which staff can be involved in decision-making processes
- Periodic messages from senior managers (by video, newsletters etc) highlighting progress or achievements
- Adequate offices/meeting rooms and space for social activities
- Team-building sessions,
- Providing for adequate work-life balance
- Providing a support and guidance framework which permits people with autonomy in their day-to-day work
- Regular feedback about goals achieved etc.

3.3.3. Ensuring transparency, openness and good communication

Transparency and openness create an atmosphere of trust and fairness. The better co-workers are informed, the better they are able to do what is expected of them. It is important to create transparency and clarity, so that people do not shirk responsibilities or misjudge their own behaviour. Openness demonstrates people’s willingness to speak up and to listen to one another. This does not mean that there should not be freedom to express different or dissident opinions. On the contrary, it is essential for organisations to create a culture in which issues and dilemmas can be discussed. For example, wrongdoing should not be a taboo topic but be openly discussed.

Concrete tools and instruments:

- Fixed point on agendas to discuss ethical issues and problems
- Whistle-blowing system
- Mechanism(s) for staff to raise concerns/ deposit new ideas
- CEO/top management open to suggestions – direct e-mail contact by co-workers, periodic ‘open door’ sessions

4. Measuring, Evaluating and Monitoring the Internal Control Environment

As any other component of the internal control system, the internal control environment should be monitored and evaluated regularly. It is not easy to measure objectively factors affecting an entity’s performance in ethics, leadership and other internal control environment aspects. It is even more difficult to detect and identify ethical problems before they manifest themselves in organisational performance. But these difficulties should not be used as an excuse to do nothing and ignore the need to ensure that the control environment remains up to date.
Internal audit can offer management much support, particularly with evaluation, but the primary responsibility for the health of an organisation’s internal control system lies with management.

**4.1. Measurement of the different aspects of the control environment**

Measuring the internal control environment involves focusing on various objectives to improve its maturity level. In a less mature environment, the focus will be more directed at structural aspects; whilst in a more mature internal control environment, individual behavioural aspects will be most important. Many organisations work at enhancing the internal control environment but do not necessarily systematically measure their progress. Measuring outcomes is an inherent difficulty of performance measurement. Therefore measuring the maturity and improvement of the control environment remains a challenge, however the tools and techniques listed below may assist.

<table>
<thead>
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<th>Concrete tools and instruments:</th>
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<tbody>
<tr>
<td>- Define baseline requirement for internal control environment</td>
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<td>- Staff satisfaction surveys</td>
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<td>- Performance appraisals</td>
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<td>- Administrative reviews</td>
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<td>- Exit interviews</td>
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<td>- Whistle-blowing arrangements</td>
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<td>- Balanced scorecards</td>
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<td>- Leadership self-assessments</td>
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<tr>
<td>- Identifying red flags such as increasing trends in, for example, numbers of complaints; staff turnover; fraud or other ethics-related incidents</td>
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**4.2. Evaluation of the Internal Control environment**

As outlined above, in the evaluation of the internal control environment, management should receive much support from internal audit. This paragraph provides a brief outline of the internal audit’s involvement and the types of tools they can use to support management. When evaluating the internal control system, internal audit should pay special attention to the internal control environment. Internal audit, or other assurance providers, should include an assessment of the risks in the internal control environment when establishing their audit plans as well as in individual audit assignments. IIA Standard 2110 refers explicitly to the role of internal audit in the governance area. Two practice guides\(^\text{10}\) provide detailed guidance on how the internal control environment and ethics-related programs can be audited.

\(^\text{10}\) IPPF – Practice Guide : Auditing the Control Environment (April 2011), and

IPPF – Practice Guide : Evaluating Ethics-related Programs and Activities (June 2012)
Concrete tools and instruments:

- Reporting and providing feedback on internal control deficiencies
- Making recommendations designed to enhance the control environment
- Following up ethics-related risks and action plans

4.3. Monitoring the Internal Control environment

To enhance and create an optimum internal control environment, opportunities should be exploited and risks and deviations should be addressed. Wrongdoing, fraud, and the perception of how these are addressed, have an obvious impact on the control environment.

However, enforcement of integrity policies is not just the extent to which people are punished for undesirable behaviour but also the extent to which people within the organisation are valued and rewarded for exhibiting the desired behaviour. An optimal internal control environment will include both sides.

4.3.1. Discouraging non-compliance and enforcement

Maintaining a positive control environment includes consolidating and enhancing positive aspects as well as promptly addressing deviations. How management reacts to compliance and deviation is crucial for the credibility of the control environment. Enforcement principles should be clear, transparent and certain.

Management should address deviations from the agreed standards in a timely and consistent manner and the response should depend on the severity of the deviation. Through good and consequent reinforcement, people will tend towards what will be rewarded and avoid what will be punished. Rewards and sanctions should not be solely financially inspired. As said before, people are sensitive to lots of other stimuli such as status, prestige, appreciation etc.

Concrete tools and instruments:

- Awards and sanctions reflected in evaluation and remuneration policies
- Nomination and remuneration committees for appointing and remunerating senior managers
- Periodic communications/reports describing detected instances of non-compliance/wrongdoing and the measures taken to redress the situation including the sanctions applied
4.3.2. Fraud policy

Management has a particular responsibility for preventing, detecting and responding to fraud. However, sound fraud control requires commitment at all levels within an organisation.

Figure 1\textsuperscript{11}

Having visible preventive and detective controls in place is one of the strongest ways to prevent fraudulent behaviour together with a quick and strong response to such behaviour. Everyone in the organisation and all those dealing with it should be aware of its zero tolerance policy to fraud. If it is perceived that the controls which should respond to fraud are not solid, reports of observations or suspicions are much less likely to be received.

Concrete tools and instruments:

- Whistle-blower mechanism
- Checklists regarding fraud control arrangements
- Forensic data analysis
- Registration of fraud incidents
- Overview by Audit Committee/other appropriate body

\textsuperscript{11} Figure ‘Fraud Control Framework’ from the ‘Better Practice Guide; Fraud Control in Government Entities by the Australian National Audit Office.’
5. **TOPICS FOR DISCUSSION**

The control environment is not solely dependent on strict and clearly defined procedures and values, but touches various very broad aspects of human behaviour. Therefore lots of challenges remain and several influential aspects can be discussed.

- How have you approached the improvement of the Internal Control environment? Can you suggest additional practical tools and instruments to improve the Internal Control environment?

- What other challenges or barriers have you identified whilst improving the Internal Control environment, and how were these tackled?

- This Paper lists some measures to assess the Internal Control environment – Can you suggest other practical instruments or approaches?