# THE CONTROL ENVIRONMENT OF A COMPANY

**The purpose of this article is to provide candidates with a more detailed appreciation of matters pertinent to an auditor, focusing on the need for the auditor of a large limited liability company (in the UK – a limited company) to evaluate the effectiveness of the company's control environment**

ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, sets out the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment including the entity's internal control. One of the five components of internal control is the control environment and it is recognised that the control environment within small entities is likely to differ from larger entities. Many candidates have not yet had the opportunity of working in larger entities, or have chosen not to, so have not been exposed to working within the type of strong control environment often referred to in auditing texts. Consequently, they often have limited experience on which to draw when answering exam questions that require anything other than superficial knowledge of an entity's control environment.

This article aims to provide common examples of matters the auditor needs to consider when assessing an entity's control environment, and in making an assessment as to their impact on the risk of material misstatement in the financial statements. Reflecting the general trend of exam questions testing knowledge of this area, the article focuses on the need for the auditor of a large limited liability company (in the UK – a limited company) to evaluate the effectiveness of the company's control environment.

A company's control environment comprises seven elements each requiring careful consideration by the company's auditor, recognising that some elements may be more pertinent than others – depending on the subject company. Each one of these elements is identified below, along with an explanation of specific practical aspects that may be considered by the auditor when evaluating its effectiveness. Candidates should be aware that this process forms part of the auditor's assessment of the overall effectiveness of the company's internal control, relevant to the audit.

**1 Communication and enforcement of integrity and ethical values**

Many companies have high values and seek to promote honesty and integrity among their employees on a day-to-day basis. Clearly, if it is evident that such values do exist and are communicated effectively to employees and enforced, this will have the effect of increasing confidence in the design, administration and monitoring of controls – leading to a reduced risk of material misstatement in a company's financial statements. For example, where a company adopts comprehensive anti-bribery and corruption policies and procedures with regard to contract tendering, and has formal employee notification and checking practices in this regard, it follows that there is reduced risk of material misstatement due to the omission of provisions for fines for the non-compliance with relevant laws and regulations. Alternatively, the existence in a company of comprehensive and ethical procedures with regard to the granting of credit facilities to customers and the pursuance of payment of for goods and services supplied, together with regular supervisory control in this respect, is likely to lead to increased audit confidence in the trade receivables area. This is because the existence of a system allowing goods and services to be a supplied on credit to customers provides the opportunity for fraud to be perpetrated against the company by employees and customers, particularly if controls are deficient in terms of their design or implementation.

**2 Commitment to competence**

Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job. It is self-evident that if individual employees are tasked with carrying out duties that are beyond their competence levels, then desired objectives are unlikely to be met. For example, there is an increased probability that the objective of avoiding material misstatement in a set of complex financial statements will not be met if prepared by an inexperienced company accountant. This is simply due to the inexperience (translating to a lower competence level) of the accountant. From this, it follows that the auditor will have increased confidence in internal control relevant to the audit, where management have taken measures to ensure employees who participate in internal control are competent to carry out relevant tasks effectively. Measures taken by management in this regard can cover a range of activity including for example, rigorous technical and aptitude testing at the employee recruitment stage and in-house or external training courses and mentoring from more senior colleagues

**3 Participation by those charged with governance**

The directors of a limited liability/limited company are charged with the company's governance. As such, they are responsible for overseeing the strategic direction of the company and its obligations related to its accountability – for example, to governments, shareholders and to society in general. In particular, in most jurisdictions the company's directors are responsible for the preparation of its financial statements. Given the influence that the actions of directors have on a company's internal control, the extent of their day-to-day active involvement in the company's operations has a pervasive effect on the internal control of the company.

The extent to which directors do get involved will, to some extent, depend on legislation or codes of practice setting out guidance for best practice in given jurisdictions. For example, the UK Corporate Governance Code (with which companies listed on the London Stock Exchange should comply) sets out standards of good practice, including those pertaining to board leadership and effectiveness. Notwithstanding legislation and codes of practice, the extent of each director's participation is largely influenced by the nature of their professional discipline and their individual perspective about how they should carry out their respective roles. Some may see themselves as micromanagers, while others will trust subordinates to carry out defined duties with minimal interference. Frequently, directors will be very experienced and adopt an arms-length approach to getting involved in operational tasks. However, they may insist on monitoring activity by way of receipt of formal narrative reports. Other directors may adopt a more casual (but equally thorough!) 'working alongside subordinates' approach as a method of monitoring activities.

All of the variables mentioned above with regard to director involvement, should be important considerations of an auditor as part of the process of ascertaining the extent of internal control in the company and in assessing its effectiveness.

**4 Management's philosophy and operating style**

A company's board of directors will comprise of individuals each with a different mind – set as to philosophy and operating style, manifested in characteristics such as their:

- approach to taking and managing business risk
- attitudes and actions toward financial reporting
- attitudes toward information processing and accounting and functions personnel.

Each of the above characteristics underlie a company's control environment and it is crucial for an auditor to have an understanding of them. Dealing with each in turn:

*Approach to taking and managing business risk.* Business risk is the risk inherent in a company as a consequence of its day-to-day operations and it comprises several components. The first of these is financial risk – for example, the risk that the company may have insufficient cash flow to continue in operation. The second component is operational risk – for example, the risk that the company's product lines may decline in popularity leading to a sharp decline in sales and profitability. The final component of business risk is compliance risk – for example, the risk that the company may be in breach of health and safety regulations, leading to the possibility of hefty fines or even the closedown of operational activity.
Candidates should be aware that a risk-based approach to an audit requires the identification and assessment of inherent risk factors and then of the control risk pertaining to these, in order to determine the risk of material misstatement, prior to carrying out substantive procedures. By adopting a top-down approach to the audit and first identifying business risks, auditors should be able to identify the associated inherent risks arising. They can then progress through the audit using the audit risk model (audit risk = the risk of material misstatement x detection risk) to determine the amount of detailed testing required in each area of the financial statements. To illustrate this approach, referring to the compliance risk example above, an inherent risk arising from the risk of a breach of health and safety regulations. As a consequence, there is a risk that the company's liabilities may be understated due to the omission of a provision required in the financial statements, in respect of a fine for a non-compliance.

The directors' approach to taking and managing business risk has obvious ramifications on a company's financial statements, and the auditor should be aware of the various factors that influence directors in this area, and of applicable controls in place. It is often the case that a newly established company with young entrepreneurial directors and a flat management structure will have a more liberal approach to taking and managing business risk than a well-established company with more experienced directors, and a steep hierarchical management structure. Consequently, it is likely that there would be a lower level of a risk of material misstatement in the financial statements of the latter company.

*Attitude and actions toward financial reporting.* Financial Reporting Standards exist to help facilitate fairness, consistency and transparency of financial reporting. However, some determinants of profitability such as the measure of depreciation, the valuation of inventory or the amount of a provision remain open to the subjective judgment of management. Consequently, the auditor needs to gain an understanding of directors' attitudes and actions to financial reporting issues and then make a judgment as to the extent of reliance that can be placed upon these. It may be that a company that is struggling in a faltering economy, and in another driven by a culture to report increasing profits, there is a tendency to adopt aggressive (as opposed to conservative) accounting principles, in order to meet profit expectations. Clearly, on such audit engagements it is important for the auditor to remain resolute in exercising appropriate levels of professional sceptism throughout.

*Attitude towards information processing and accounting functions and personnel.* Properly financed and resourced with sufficient numbers of appropriately qualified staff and contemporary information and communications technology, the financial reporting (accounting) and information processing functions of a company are vital to a company's ongoing existence. They are key to the facilitation of compliance with laws and regulations, transactions with third parties, administration and control systems and in the provision of information for decision making. In most very large companies many aspects of the accounting function are inextricably intertwined with specific aspects of the company's information processing systems, and there is an ongoing programme of investment in these, to ensure that the accounting and information processing systems are contemporary and fit for purpose. This is reflective of a situation where directors recognise that business risk will be significantly reduced, if the company has effective information processing and accounting functions. However, this situation does not apply to all companies. In some, both functions may be seen by the directors merely as necessary functional overhead areas of the business and, as such, they become under-funded and inadequately resourced in terms of staffing and equipment. An auditor engaged on an audit in such a company should be aware that there is an increased risk of material misstatement in the financial statements.

**5 Organisational structure**

ISA 315 describes a company's organisational structure as being 'the framework within which an entity's activities for achieving its objectives are planned, executed, controlled and reviewed'. The appendix to the ISA then explains 'that the appropriateness of an entity's organisational structure depends, in part, on its size and the nature of its activities'. It follows from this that an international consulting company with offices and operations in several countries has different priorities in terms of organisational structure to a national car sales company with several offices and a number of sales branches in a single country. Similarly, the organisational structure deemed suitable for such a car sales company would not be appropriate for a single site manufacturing company. Generally, an auditor may reasonably expect there to be a positive correlation between the level of inherent risk and the size and complexity of a company's operations. In assessing, the level of the risk of material misstatement the auditor should consider as to whether the company's organisational structure in terms of authority, responsibility and lines of reporting meet desired objectives.

**6 Assignment of authority and responsibility**

*Normally, the* larger a company's scale of operations, then the larger the size of the workforce and, inevitably, the larger the amount of assignment of authority and responsibility that is required. Consequently, companies need to deal not only with ensuring that appropriate levels of authority and responsibility are assigned to appropriately qualified and experienced individuals. They also need to ensure that adequate reporting relationships and authorisation hierarchies are in place. Additionally, individuals need to be properly resourced and made fully aware of their responsibilities and of how their actions interrelate with the actions of others and contribute to the objectives of the company. If a company is not successful in meeting each of these needs, then there is an increased probability of ineffective decisions, errors and oversights by employees leading to an increased risk of material misstatement in its financial statements. For example, where a wages clerk is authorised to process the wages payroll and is then assigned the (inappropriate!) authority to enter new employee details into the wages master file.

**7 Human resources policies and practices**

As explained in ISA 315, 'human resource policies and practices demonstrate important matters in relation to the control consciousness of an entity'. This implies that if human resources policies and practices are considered to be sound both in design and in implementation over a range of matters, then the risk of material misstatement will be reduced.

Examples of these matters include:

- Recruitment policies and procedures. These should ensure that only competent individuals with integrity are employed by the company. Interview procedures should ensure that only candidates meeting the company's criteria for recruitment are engaged.
- There should be adequate induction procedures for new employees, such that they can carry out their assigned responsibilities effectively and efficiently soon after being engaged by the company.
- Employees should be provided with ongoing training, support and mentoring as appropriate, such that they can continue to carry out their assigned responsibilities effectively and efficiently.
- There should be regular formal appraisal, at least annually of an employee's performance. Performance should be measured against standardised criteria authorised by senior management of the company, and there should be ongoing monitoring and feedback to employees about their performance and development needs.

- The company should employ comprehensive and transparent employment grievance procedures, such that employees can be confident that grievances will be dealt with openly and impartially.
- There should be open, transparent and equitable employee disciplinary procedures, such that employees can be confident they will not be treated unfairly by the company in the event that an action triggers its disciplinary process.
- Employment termination procedures should incorporate provision for an exit interview so that the reason for the termination can be confirmed or clarified, all emoluments due to the employee can be settled and arrangements can be made for the return of all company assets prior to the termination date.

While each of the above measures will have a positive impact on the internal control of a company, to some extent they all have the effect of reducing the risk of material misstatement in the financial statements. For example, the existence of fair and robust grievance and disciplinary procedures reduce the possibility of a successful claim against the company for constructive or unfair dismissal, and the absence of a material provision in this respect. Significantly, the existence of human resources policies and practices that are the same or similar to those above should leave a favourable impression with the auditor, as to the directors' attitude toward their company's workforce. It is likely that such an attitude would foster good working relationships with employees, leading to an increased likelihood that individuals would reciprocate by carrying out their tasks diligently with integrity in the best interests of the company – resulting in a reduced risk of material misstatement.

**Summary**

As indicated at the beginning of this article, the purpose of it is to provide candidates with a more detailed appreciation of matters pertinent to an auditor, when evaluating the control environment of a limited liability/limited company. When asked to explain what is meant by the term 'control environment', they typically comment that it is a component of a company's internal control and that it centres around how a company is operated by its management, reflecting such matters as their philosophy and operating style. While there is some merit in this answer, having now read the above commentary, candidates should be aware that the term has much more meaning than that.

**Written by a member of the audit examining team**