



# **The North Carolina Office of the State Controller**

## **Control Environment, Tone at the Top and Ethics**

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# Agenda

1. Elements of a strong control environment
  - a. Appropriate tone at the top; management's attitudes, beliefs, practices
  - b. Characteristics of good controls
  - c. Right combination at the entity, IT and transaction levels controls
  - d. Operating effectiveness of controls
  - e. Reporting protocols for control breakdowns
2. Importance of tone at the top
  - a. Monitoring control activities (indirect vs. direct internal controls)
  - b. Codes of conduct and ethics
  - c. Internal crisis management including whistleblower policies
  - d. Responses to incentives and temptations
3. Building strong ethics programs
  - a. Elements of a strong ethics program
  - b. Measuring effectiveness of ethics programs
  - c. Ethics program leading practices



# Background

- A lot of focus on internal controls in the private sector
- Generally believe that “... many of the principles and characteristics described in the COSO guidance document will be helpful for understanding and implementing internal controls in government.”<sup>1</sup>
- Many of the concepts discussed today are based on the COSO guidance
- COSO: Committee of Sponsoring Organizations of the Treadway Commission

<sup>1</sup> Applicability of COSO guidance to government entities



# Internal Controls

- Definition of Internal Controls
  - An integral component of an organization's management
  - It provides reasonable assurance on:
    - Effectiveness and efficiency of operations
    - Reliability of financial reporting
    - Compliance with laws and regulations
- Major part in managing an organization
  - Comprises the methods and procedures used to meet missions, goals and objectives
  - First line of defense in safeguarding assets
  - Used for prevention and detection of errors and fraud
- Synonymous with management control
- Helps achieve desired results through effective stewardship



# Fundament Concepts of Internal Controls

- A continuous, built-in component of operations
  - Not one event, but a series of actions and activities
  - Part of the infrastructure to help managers run the entity
- Effected by people
  - Responsibility for good internal controls rests with managers
  - All personnel play an important role
- Provides reasonable assurance, not absolute assurance
  - Controls should be designed and implemented based on cost and benefits
  - Can be influenced by external factors

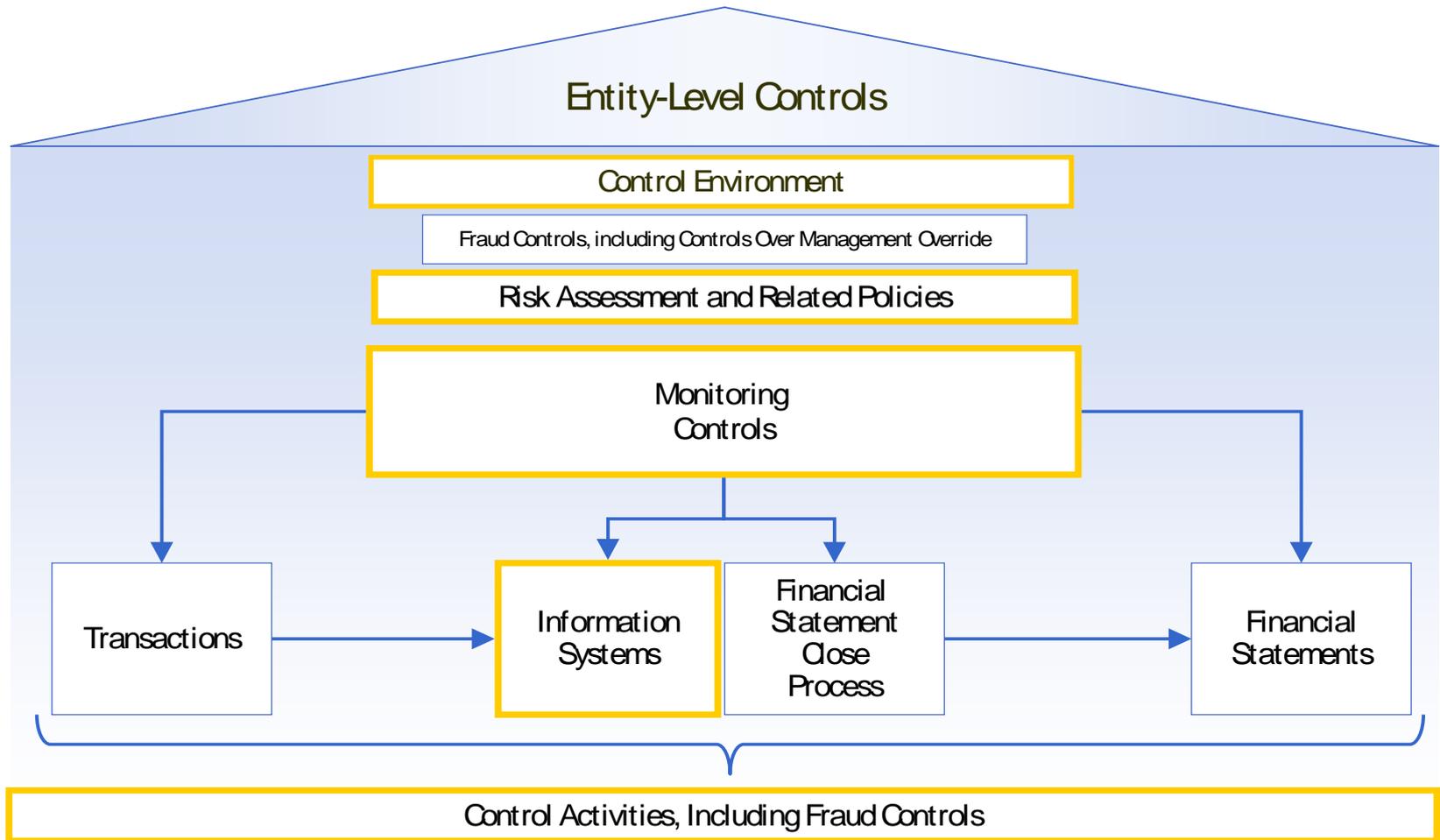


# Standards for Internal Controls

- Five standards:
  - Control Environment
  - Risk Assessment
  - Control Activities
  - Information and Communication
  - Monitoring
- Define the minimum level of quality acceptable for internal control
- Provide basis against which internal controls are evaluated
- Apply to all aspects of an agency's operations: programmatic, financial and compliance
- Provide a general framework



# Internal Controls Framework





# Control Environment

The Organization's control environment establishes and promotes a collective attitude toward achieving effective internal control and generating reliable financial statements.



# Control Environment

- Control environment sets the tone of an organization
- Foundation for all other components of internal control, providing discipline and structure
- Control environment factors include:
  - Integrity and ethical values
  - Competence of the entity's people
  - Management's philosophy and operating style
  - How management assigns authority and responsibility
  - Organizational structure
  - People development
  - Attention and direction provided by the oversight functions



# Control Environment

- Key factors that affect the Control Environment:
  - Integrity and ethical values
    - Management should maintain the organization's ethical tone
    - Provide proper guidance for proper behavior
    - Remove temptations for unethical behavior
    - Provide discipline when appropriate
  
- Examples:
  - Codes of conduct
  - Tone at the top and communications
  - Attitudes toward ethical values



# Control Environment

- Key factors that affect the Control Environment:
  - Management's commitment to competence
    - All personnel need to possess and maintain a level of competence
    - It is management's responsibility to provide training, counseling and performance appraisals
  
- Examples:
  - Job descriptions and competencies
  - Employee certifications
  - Training records
  - Performance evaluations



# Control Environment

- Key factors that affect the Control Environment:
  - Management’s philosophy and operating style
    - Determines the degree of risk the agency is willing to take
    - Management’s attitude and philosophy toward information systems, accounting, personnel functions, monitoring and audits are especially important
  
- Examples:
  - Aggressiveness of risk taking and policies
  - Information sharing and disclosure



# Control Environment

- Key factors that affect the Control Environment:
  - The agency's organizational structure
    - Provides framework for planning, directing and controlling operations to achieve agency objectives
    - Good internal control environments define key areas of responsibility and establish appropriate lines of reporting
- Examples:
  - Reporting structure and lines of command



# Control Environment

- Key factors that affect the Control Environment:
  - How agency delegates authority
    - Authority and responsibility should be clearly delegated throughout the agency in regards to operating activities, reporting relationships and authorization protocols
- Examples:
  - Job descriptions
  - Appropriate staffing
  - Delegation of authority



# Control Environment

- Key factors that affect the Control Environment:
  - Human capital policies and practices
    - Establishes appropriate practices for hiring, orienting, training, evaluating, counseling, promoting, compensating and disciplining
    - Must provide a proper amount of supervision
  
- Examples:
  - Leadership development
  - Succession planning
  - Responsibilities and expectations



# Risk Assessment

The Organization establishes and maintains an effective process to identify, analyze and manage risks relevant to the preparation of reliable financial statements.



# Risk Assessment

- Risk assessment is the identification and analysis of relevant risks
- An effective risk assessment requires:
  - Establishment of objectives linked at different levels
  - Internally consistent objectives
- Forms basis for determining how the risks should be managed
- In a changing world, mechanisms are needed to identify and deal with the special risks associated with change



# Risk Assessment

- Starts with entity-wide objectives
- Objective setting is a key part of the management process
- Management establishes its key objectives and then identifies the risks related to these objectives
- Must consider risks from both external and internal sources
- Must identify and analyze relevant risks
- Must determine how to manage risks



# Risk Assessment

- Risk identification methods:
  - Quantitative and qualitative
  - Risk-ranking activities
  - Management conferences
  - Forecasting and strategic planning
  - Consideration of findings from assessment
- Risk analysis generally includes:
  - Estimating risk's significance
  - Assessing likelihood of its occurrence
  - Deciding what actions to take



# Risks

- Inherent risk: susceptibility to misstatement, assuming no related specific control activities
  - Example: cash has high inherent risk
- Control risk: the risk that misstatements will not be prevented or detected by internal control
  - Example: all cash is counted with two people present
- Combined risk: the likelihood that a material misstatement would occur (inherent risk) and not be prevented or detected by internal control (control risk)



## Control Activities

An organization's control activities are the policies and procedures that help ensure management directives are carried out. They exist within processes or functions of the company, and they can be divided into three categories, based on the nature of the entity's objectives to which they relate: operations, financial reporting and compliance. They may reside in more than one category.



# Control Activities

- The policies and procedures that help ensure management directives are carried out
- Help ensure that necessary actions are taken to address risks
- Occur throughout the organization
- Are an integral part of an entity's planning, implementing and reviewing process
- Help accountability for stewardship of government resources



# Examples of Control Activities

- A control is defined as any action taken to mitigate or manage risk and increase the probability that the organization will achieve its objectives
- Controls include a range of activities such as:
  - Approvals
  - Authorizations
  - Verifications
  - Reconciliations
  - Reviews of operating performance
  - Security of assets
  - Segregation of duties



# Nature of Controls

- Manual Control:
  - Independent review of general ledger reconciliations
  - Authorization of employee expense reports
- IT-Dependent Manual Controls:
  - Controls that are manually performed, but require input based on the results of computer-produced information
  - Review and follow-up of exceptions on a payroll exception report
- IT Application Control:
  - Automated three-way match
  - Data input validation checks (e.g., orders can only be processed using a valid customer number)
  - Restricted user access



# Types of Controls

- Prevent Controls – controls used by management to prevent errors from occurring:
  - Authorization of payments prior to processing
  - Customer credit limit checks
  - Restricting user access to IT systems
- Detect Controls – control activities designed to detect and correct an error:
  - General ledger reconciliations
  - Review of exception reports
  - Quarterly review of system access

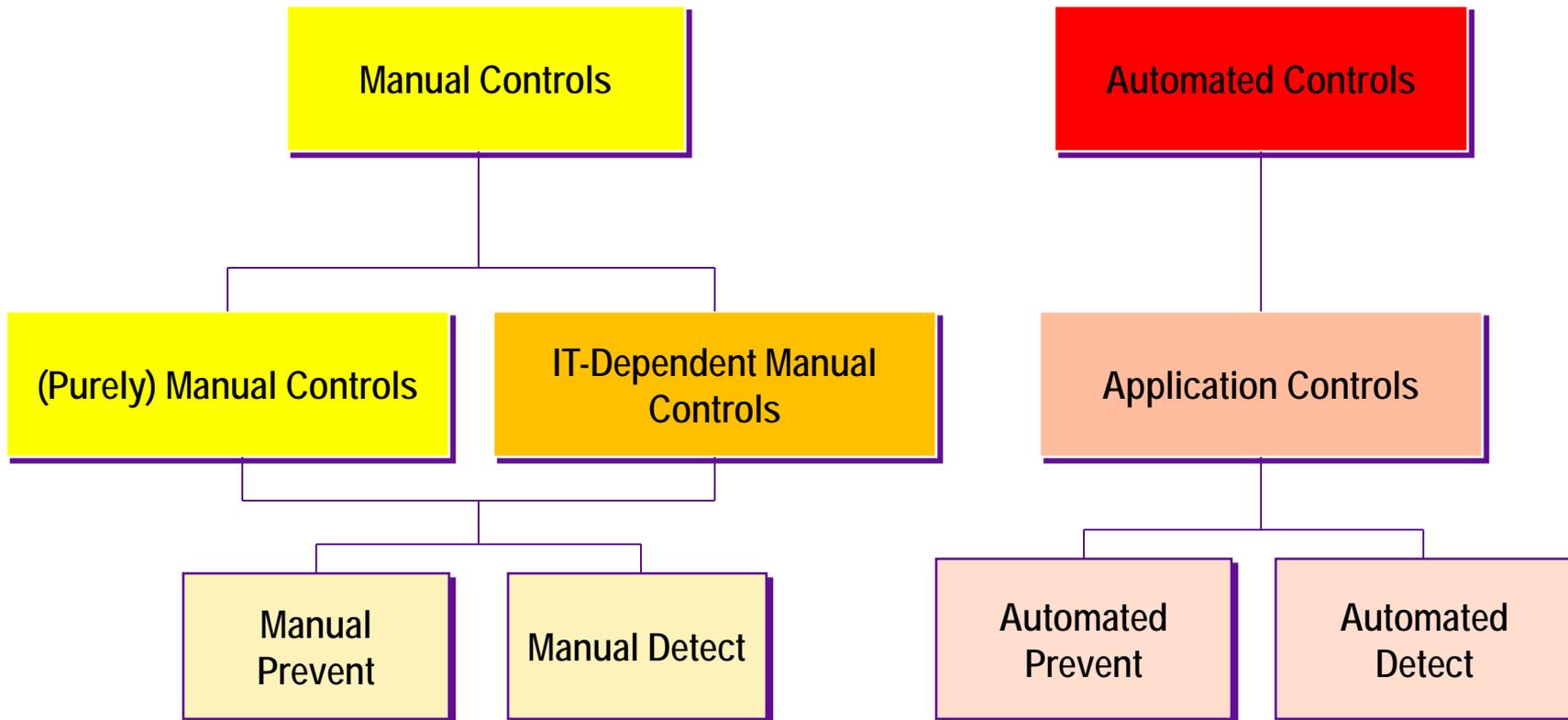


# Information Technology Controls

- Two types of information systems control:
  - General controls
  - Application controls
- General controls apply to all information systems
  - Includes entity-wide security program and backup and recovery procedures
- Application controls are designed to cover processing of data within a specific application
  - Ensures completeness, accuracy and validity of all transactions during application processing
- General and application controls are interrelated
- Information technology changes rapidly, thus controls must evolve to remain effective



# Classification of Controls





# Characteristics of a Good Control

- Focus on critical points of operations
- Integrated into established processes
- Accuracy: provide factual information that is useful, reliable, valid and consistent
- Understandable: controls must be simple and easy to understand
- Acceptable: employee involvement in the design of controls increases
- Economically feasible: controls should not cost more than the risks they mitigate



## Information and Communication

Information is identified, captured and communicated in a form and timeframe that enables people to carry out their responsibilities. Information gathering mechanism produces reports containing information that makes it possible to run and control the business. Communication also occurs in a broader sense, flowing down, across and up the organization.



# Information and Communication

- Information must enable people to carry out their responsibilities
- Information systems make it possible to run and control the business
- Information can be generated internally or externally
- Effective communication must flow through the organization
- People must understand that control responsibilities are important
- They must understand their role in the internal control system
- They must have a means of communicating information up
- There also needs to be effective communication with external parties



# Monitoring

The organization's internal control systems are monitored. Internal control procedures are reported upstream, with serious matters reported to senior management.



# Monitoring

- Internal control systems need to be monitored to assess the quality of the system's performance through:
  - Ongoing monitoring, separate evaluations or a combination
- Ongoing monitoring occurs in the course of operations
  - Includes regular management and supervisory activities and other actions taken in performing duties.
- Scope and frequency of separate evaluations depends on risk assessment and effectiveness of ongoing monitoring procedures
- Separate evaluations may take the following forms:
  - Self-assessments
  - Review of control design
  - Direct testing of internal control



# Monitoring Controls

- Monitoring controls
  - Typically detective in nature, fewer in number, more efficient to test
- Effective monitoring controls:
  - Reduce the number of transaction-level controls
  - Influence risk assessment of other identified controls
  - Increase efficiency
- Controls can be in multiple layers within the organization and at different depths
  - Monitoring can be at all levels of management
  - Consider various aspects related to precision



# Identification of Deficiencies

- Agency employees and managers shall report deficiencies to the next supervisory level
- Determine the relative importance of each deficiency
- May represent a deficiency in the design or operation of internal control
- Leading practice is to use a team of senior management executives to assess and monitor deficiencies in control



# Monitoring

- Managers need to:
  - Promptly evaluate findings from audits and other reviews
  - Determine proper actions in response to findings and recommendations from audits and reviews
  - Complete all actions that correct or resolve matters
- Resolution process begins when audit or other review results are reported to management
- Resolution process is only completed after an action has been taken that:
  - Corrects identified deficiencies
  - Produces improvements
  - Demonstrates that the findings and recommendations do not warrant management action

# SECTION 2 TONE AT THE TOP





## Tone at the Top

Tone at the top is a *visible* willingness by senior management to let *values drive decisions*, to prioritize those values above other factors – including financial results – and to *expect* all others in the organization to do the same.



# Tone at the Top

- The right tone at the top involves:
  - A system of organizational integrity
  - A set of guiding values that are understood and support ethically sound behavior by all employees.
  - The responsibility of all employees, not just lawyers or compliance officials
- Establishing the right tone at the top is the best way to preserve an organization's good reputation



# Five Key Factors for Tone at the Top

- First Key Factor: the guiding values of the organization must make sense and be clearly communicated
  - Employees at all levels must take responsibility for them
  - Develop a set of core values and guiding principles that could apply across all parts of the organization
  - Management constantly reinforces values
  - Values are personal – they articulate who we are and what we stand for as individuals and as a company – and we expect each employee to take personal ownership for living our values



# Five Key Factors for Tone at the Top

- Second Key Factor: an organization's leaders must be personally committed, credible and willing to take action on the values they promote
  - This is the essence of setting the right tone at the top
- Third Key Factor: an organization's other systems and structures must support its guiding values
  - Performance appraisal system should be sensitive to means and not just reward ends



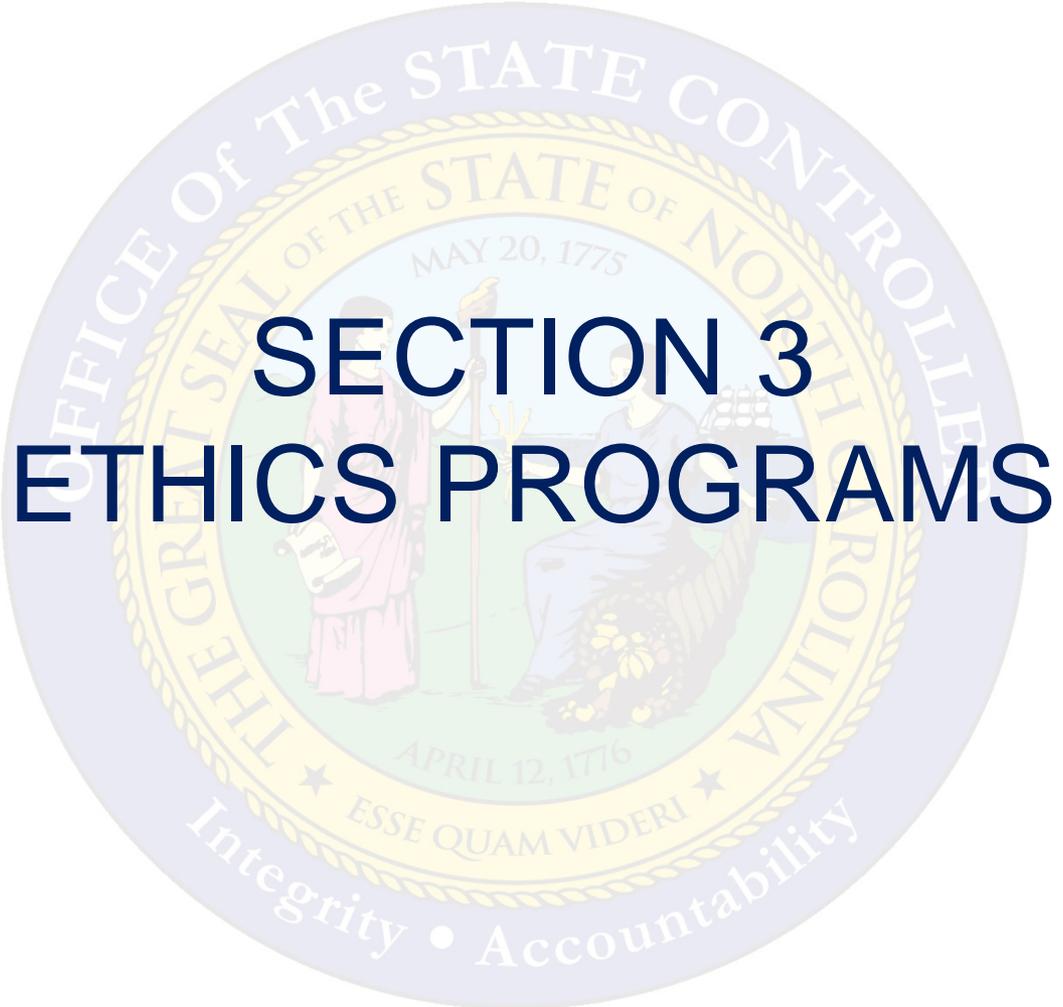
# Five Key Factors for Tone at the Top

- Fourth Key Factor: the organization's values should be integrated into management decision-making
  - Values are reflected in the company's critical decisions
- Fifth Key Factor: managers throughout the organization should understand the values and be empowered to make ethically sound decisions on a day-to-day basis
  - Ethics training is usually needed to achieve this factor



# Code of Conduct

- Set of rules outlining the responsibilities of or proper practices for an individual, party or organization
- Covers a wide range of business practices and procedures – it does not cover every issue that may arise, but it sets out basic principles to guide all employees
- Each agency will have its own Code of Conduct
- NC General Statute 138A: State Government Ethics Act

The seal of the Office of the State Controller, North Carolina, is a circular emblem. It features a central figure, likely a personification of Justice or a similar allegorical figure, holding a scale and a sword. The figure is surrounded by a wreath. The seal is inscribed with the text "OFFICE OF THE STATE CONTROLLER" at the top, "THE GREAT SEAL OF THE STATE OF NORTH CAROLINA" around the inner border, and "Integrity • Accountability" at the bottom. The date "MAY 20, 1775" is inscribed above the figure, and "APRIL 12, 1776" is inscribed below the figure. The Latin motto "ESSE QUAM VIDERI" is also present.

# SECTION 3 ETHICS PROGRAMS



# Ethics Programs

- What are they?
  - A systematic approach to raising ethical awareness of employees
  - A way to provide guides and education on ethics and have resources available to assist in identifying and resolving ethical issues
- Components of a program
  - Vision
  - Ethics training for employees
  - A means for communicating with employees
  - Reporting mechanism
  - Audit system
  - Investigation system



# Compliance versus Integrity Strategy

- Compliance strategy tries to prevent criminal conduct, violation of regulation and self-interested behavior by employees (e.g., conflicts of interest)
  - Imposes standards of conduct and tries to compel acceptable behavior
  - Relies more on lawyers and compliance officers
- Integrity strategy seeks to create conditions that support right action
  - Communicates the values and vision of the organization
  - Aligns the standards of employees with those of the organization
  - Relies on the whole management team, not just law and compliance personnel



# Benefits of an Ethics Program

- Prevent ethical misconduct
  - Monetary losses and losses to reputation
  - Loss of citizens' trust
- Adapt the organization to rapid change
  - Regulatory changes, new technologies, changing consumer needs, and competition can require new ways of doing business
  - What are the rules?
- Managing relations with *stakeholders*
  - Informs suppliers about an entity's own standards
  - Reassures other stakeholders of the entity's intent



# Three Approaches to Ethics

- Statement of specific rules or standards
  - Often called codes of conduct or statements of business standards or practices
- Statement of core values or vision
  - Often called a credo or mission statement
  - State of North Carolina Mission
- Statement of philosophy that describes the beliefs guiding a particular organization



# Gathering Information

- Five key questions to ask:
  1. What are the compliance requirements?
  2. Who is responsible?
  3. What are they doing?
  4. Is it working?
  5. How do you know?



# Why Adopt a Code of Ethics?

- Reasons for adopting codes:
  - Generate discussion of what is ethical conduct
  - Help achieve consensus on ethical conduct
  - Enhance commitment to entity's ethical conduct
  - Communications tool
  - Discover core principles
- **Premise:** an ethics and compliance program serves three principal objectives:
  - Prevent non-compliance
  - Detect non-compliance
  - Enhance business processes and decision-making



# Things to Watch For

- Problems
  - Over-emphasis on rules at the expense of judgment
  - Employees might conclude that anything not forbidden is permitted
  - Heavy focus on actions that harm the organization may lead to cynicism about the purpose of the code
- Other approaches
  - Focus on a strong culture and leadership rather than on a written code
  - Rely upon extensive government regulation and internal auditing



# Leading Practices in Ethics Programs

## Vision

- Ethics is seen as a way to improve the organization
  - Promotes trust, integrity and accountability
- Ethics seen as a competitive advantage
- Serves as a guide to all stakeholders regarding expectations
- Embedded into day-to-day business activities



# Leading Practices in Ethics Programs

## Training

- Ethics training maps are developed for management levels in addition to functional areas
- Training is delivered using live and computer-based delivery methods
- Training content development is coordinated by dedicated resources to allow for appropriate and consistent coverage
- Training curriculum and content linked to compliance risk assessment
- Training includes testing of comprehension, and updates and refresher programs are driven by results



# Leading Practices in Ethics Programs

## Communication

- Formalized organization-wide upward communication processes are in place
- Ethics has become an integral component of all management communications
- Management participates with staff in ethics compliance-related activities
- Organization-wide communication process in place to guide decisions based on information, risk and requirements



# Leading Practices in Ethics Programs

## Reporting

- A formal reporting hotline has been established
- Hotline is available through multiple means (telephone, online, mail)
- Reporting mechanisms communicated to personnel
- Administration of reported complaints is prioritized, codified and followed consistently
- Organizations have executive-level ethics committee and management ethics council to discuss organization-wide ethics process issues



# Leading Practices in Ethics Programs

## Audit

- Formal compliance auditing and monitoring calendars in place
- Independent monitoring of resources
- Proactive, real-time auditing and monitoring in place for highest risk controls to prevent non-compliance
- Proactive compliance embedded into daily operations



# Federal Sentencing Guidelines

- An effective program will:
  - Have compliance standards that are reasonably capable of reducing criminal conduct
  - Specifically designate high-level managers to oversee the program
  - Exercise due care not to delegate major authority
  - Have a method of communicating the policies and procedures
  - Take steps to achieve compliance using monitoring and auditing
  - Consistently enforce standards through appropriate disciplinary mechanisms
  - Take steps to prevent future occurrences, including modifying the ethics program

# Driving Continuous Improvement

