WHERE CONTROL BEGINS

Javier Faleato Ramos
Managing Director of the Institute of Internal Auditors of Spain

One of the business scandals that attracted the most media attention in recent years - the fraud involving Volkswagen's tampered engines - has been joined by such other similar scandals as those of Toshiba, Barclays and many other large corporations. These scandals have highlighted the importance of establishing a control environment within organisations that defines how operations should take place and genuinely influences the way in which people act.

The ramifications of these scandals go far beyond the immediate fraud, possible liabilities or falling company share prices, to mention but a few. In a global and permanently interconnected and informed world, negative impacts on reputation can cause a company to disappear entirely as a result of distrust from consumers. In recent years especially, we have also witnessed an overall loss of confidence of society in the business world in general (companies and their main players as boards of directors & senior management) due to misbehaviours in business management. A lack of confidence - a factor that is tough to quantify - can have catastrophic effects on everything that can be measured.

The absence of a suitable control environment has led to the failure of numerous major companies, meaning that building solid trust is more important now than it has ever been in the past. This is what stakeholders (shareholders, customers, regulators and watchdogs, employees, suppliers) and society in general expect from any organisation, and it is what every company should aspire to achieve.

The changes taking place in the field of business and the way in which organisations operate, especially in recent years, have impacted on business endeavours and are the root cause of a need to update theories and concepts on the design, implementation and operation of internal control. One essential element for the correct operation of an internal control system is the ongoing oversight of its effectiveness, a task that should fall to the internal auditor.

The Committee of Sponsoring Organisations of the Treadway Commission (COSO) - the body recognised as the global authority on internal control issues at organisations - establishes the fundamental aspects of internal control and is responsible for drafting the Internal Control-Integrated Framework COSO Report. COSO defines internal control as a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting and compliance.

COSO establishes five significant and inter-related components within internal control models: the control environment; risk assessment; control activities; information and communication; and, finally, monitoring activities.

The control environment provides the guidelines on conduct by the organisation: discipline, ethical values, organisational structure and capacity, segregation of duties and professional development. It forms the basis for all internal control components but is also the most intangible aspect, thus making it the most difficult to assess.

The board of directors. From "tone at the top" to "commitment from the top"

The aforementioned global convergence on internal control and responsibility by the board of directors for establishing a control environment is no trivial matter. The way in which an organisation operates should be defined by the board of directors itself, as should the rules on conduct applicable to employees regardless of their various levels or hierarchies; rules that the board should also follow. In other words, we must move away from "tone at the top" towards "commitment from the top". It affects senior management and all company employees in a top-down approach, thus reasonably ensuring full compliance with the objectives sought regarding operations, information and compliance with the regulatory framework governing the organisation.

If management can adequately convey the organisation's culture and values, it can instil a way of doing things that will benefit every level of the company and avoid situations that pose either financial or reputational threats. Let us not forget that senior management is responsible for establishing a level of tolerance and risk appetite for the organisation, as well as assessing the likelihood of an impact from the risks inherent to the organisation's activity. This will enable all risks to be managed - including fraud - and procedures to be applied for preventing and detecting them.

Besides establishing the control environment, senior management is also legally required in many places around the world to oversee this environment. This task is usually delegated to an audit committee which should relay on the internal auditing department in order to detect timely internal control weaknesses and propose solutions and improvements to remedy those weaknesses.

The publication entitled Entorno de Control: Siete preguntas que cualquier Consejero debe plantearse [Control Environment: seven questions that every board member should ask themselves], drafted by the FÁBRICA DE PENSAMIENTO - the think tank of the Institute of Internal Auditors of Spain - identifies the seven key aspects that determine the strength of any control environment at an organisation.

Seven keys to a sound control environment

The first key is *to define and instil throughout the organisation the corporate culture, values and principles.* The important factors in this regard include: having a clear, transparent and measurable declaration on the ethical values and principles governing company business in the organisation's Mission and Vision; publishing a Code of Conduct, requiring formal acceptance at all levels of the organisation, training employees on ethics and implementing a penalty system for non-compliance; and creating an hotline for employees, customers and suppliers.

Another aspect to consider is that the *board of directors should undertake the task of overseeing the internal control and risk management system with a sufficient degree of independence from company management.* Best practices recommend formally defining the responsibility of the board of directors or the audit committee in a specific charter, as well as having a majority of board members who are external and independent from company management in order to guarantee the oversight of decision-making.

Two issues are fundamental in this regard. On the one hand, the board members responsible for oversight should have a high level of skill and experience in terms of internal control and risk management, as well as a sound knowledge of the business.

On the other hand, it is important for the board to have an independent internal auditing department to provide support on oversight tasks, and a fluid communication between the board and senior management, internal and external auditors, and other external consultants should be guaranteed.

A *clearly defined and well communicated organisational structure* allows activities to be planned, executed, controlled and supervised, authority and responsibilities to be defined, and suitable information channels to be created. An up-to-date and well communicated organisational structure that reflects the various levels of the organisation should be accompanied by appropriate policies on the segregation of duties, including those of key positions. It should also include the updating of procedures and the reporting structure should be coherent with the organisational structure, among other improvements.

Those organisations that choose to ignore the importance of formalising, communicating, measuring and appropriately remunerating the fulfilment of duties by their employees and executives are less efficient, less sustainable and run the risk of underusing their resources. Hence, in order to build a sound control environment, it is highly important *to establish human resource policies that reflect achievement of objectives, an incentive system that does not favour excessive risk-taking and professional competence.* These policies should be spread to all employees and levels of the organisation in order for individual performance goals to be coherent with the overall objectives of the organisation in the short and long term.

As part of the processes, the organisation should also *plan succession for key positions and correctly allocate authority and responsibility for taking decisions.*

Best practices indicate that the board should ensure that succession plans exist for critical positions in the organisation; those that facilitate business continuity. The loss of a critical employee can paralyse an organisation, or result in deviations from objectives or a loss of competitive edge. Furthermore, the implementation of programmes to identify qualified employees enables the long-term development of talent, the transfer of knowledge and for all employees to achieve their aspirations within the company.

In order to achieve a correct allocation of authority, the organisation should implement a formal model based on its objectives, as well as regular reviews of the business model to ensure that the risk appetite approved by the board and senior management is maintained. The risks of not defining or implementing these and other improvements in this regard are clear: increased potential for an accumulation of power that encourages fraud and generates conflicts of interest. However, formally determining authority clarifies duties and responsibilities, provides decision-making security, and formalises and improves internal communication.

A final "quick win" that determines whether the organisation has a strong control environment is *to have mechanisms for adapting to and managing change.* The speed and magnitude of the changes caused by the economic climate, technological revolution, and increase in new regulatory requirements mean that an organisation that fails to innovate exposes itself to a high risk of failure. This innovation should be accompanied by a commitment to risk management, especially regarding everything related to business continuity and the monitoring of external changes that could lead to a competitive edge.

The change on the horizon

Those organisations that manage and generate change in an ordered manner have clear and formalised processes and procedures to define their operations and monitor their most immediate environment. Similarly, they should consider the changing objectives and expectations of their stakeholders, whose growing demand for organisations to be sustainable and responsible in all areas further strengthens the need to constantly manage change.

The environment in which organisations operate is moving ever faster. Companies are more international, the lines between sectors are becoming blurred, and the threats to companies are multiplying and diversifying: cybernetic attack, social conflict and other, even more serious threats appearing on the horizon, such as water shortages... that make companies more fragile while complicating their ability to anticipate risks. Organisations are also becoming more complex and managing them is becoming more difficult. However, this is an opportunity to foster change by promoting a corporate culture based on the distinctive values of each company, an improved focus on risk - especially emerging risks, and a strengthened control environment.

The society in which we operate is increasingly more critical and demanding with regard to the way in which organisations operate. This is joined by the incorporation of new generations into the labour market that, in line with their times, demand to work in sustainable and transparent companies based on solidarity and with strong control environments capable of guaranteeing their sustainability and growth without ignoring a series of values to which society is already committed.

These are several reasons to effectively implement a corporate culture that can form the basis for good work by organisations and provide a way to mitigate reputational risks that could jeopardise continued existence.