

STATE OF GEORGIA ACCOUNTING PROCEDURES MANUAL

SECTION: FIVE – INTERNAL CONTROLS
TOPIC: CONTROL ENVIRONMENT

INTRODUCTION AND OVERVIEW

The control environment is the control consciousness of an organization; it is the atmosphere in which people conduct their activities and carry out their responsibilities. An effective control environment is an environment where competent people understand their responsibilities, the limits to their authority, and are knowledgeable, mindful, and committed to doing what is right and doing it the right way; they are committed to following an organization's policies and procedures and its ethical and behavioral standards. The control environment is an intangible factor that is essential to effective internal control. The environment has a pervasive influence on all the decisions and activities of an organization.

No two control environments will be exactly the same. Factors that influence the control environment include the size of the organization, differing management styles, and the autonomy of the various State organizations. The control environment encompasses the factors discussed below, however the extent to which each is addressed by the various State organizations will vary.

A. Integrity and Ethical Values

Introduction

A control environment can be no better than the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical values are essential elements of the control environment, affecting the design, administration and monitoring of all other internal control components. Obviously, the most effective way of transmitting a message of ethical behavior throughout an organization is by example, however, merely setting a good example is not enough. Top management should communicate the organization's values and behavioral standards to employees. A widely used method of communication is through the use of a formal code of conduct. Written codes are useful, but there is no guarantee employees will follow them. It is therefore vital that the communication of integrity and ethical values provide explicit guidance regarding what is right and wrong, and identify penalties to employees who violate these standards. There must also be a mechanism to encourage employee reporting of suspected violations. Management must demonstrate that they are monitoring adherence to these policies and that noncompliance is dealt with in a fair and equitable manner.

STATE OF GEORGIA ACCOUNTING PROCEDURES MANUAL

SECTION: FIVE – INTERNAL CONTROLS
TOPIC: CONTROL ENVIRONMENT

Implementation Guidance

1. Establish comprehensive written policies or codes of conduct to address:
 - a. acceptable business practices;
 - b. prevention of conflicts of interest;
 - c. procedures for disclosure of potential conflicts; and
 - d. expected standards of ethical behavior to prevent and/or report illegal or improper activities.

2. Establish a plan for implementation of the policies.
 - a. Policies should be distributed to all employees and periodically acknowledged by all employees.
 - b. Employees should understand what behavior is acceptable and unacceptable.
 - c. Employees should know what to do if they encounter unacceptable behavior.
 - d. Provide a clear channel for employees at all levels to communicate with senior management regarding ethical and moral concerns.
 - * Establish a process for investigating such problems.
 - * See that employees understand that they will be protected from retribution if they call attention to such problems.

3. Set the “tone at the top” to give moral guidance about what is right and wrong by communicating, by words and by deeds, to all members of the organization, management's commitment to integrity and ethics. Employees should feel peer pressure to do the right thing. Deal with complaints by State organization's “customers” in a timely and appropriate manner. Actively identify potential problems and deal with them, even when the cost of dealing with them could be high.

4. Establish, and communicate throughout the organization, appropriate steps of remedial action to be taken in response to departures from laws, regulations, approved policies and procedures, and codes of conduct.

5. Provide guidance on the type and frequency of situations in which circumvention of, or intervention to, established control policies may occur.
 - a. Explicitly prohibit management override of established controls.
 - b. Investigate and document all deviations from established controls.
 - c. Appropriately document and explain all indications of necessary management intervention.

STATE OF GEORGIA ACCOUNTING PROCEDURES MANUAL

SECTION: FIVE – INTERNAL CONTROLS
TOPIC: CONTROL ENVIRONMENT

6. Set realistic performance targets, particularly for short-term results.
 - a. Avoid extreme pressures or temptations which unfairly or unnecessarily test adherence to ethical values.
 - b. Base rewards largely on achievement of short-term performance targets.
 - c. Employees need to understand how the larger, long-term issues related to short-term performance.

B. Commitment to Competence

Introduction

The need for competent employees is obvious. Competence is a characteristic of people who have the skill, knowledge and ability to perform a task. This is especially true in an Information Technology environment. People who are poorly trained or just don't know what to do in a crisis cannot be expected to support and promote controls, as they are too busy merely trying to get the job done. **Management is responsible for ensuring the competency of its personnel and can accomplish this by establishing appropriate human resource policies and procedures.** Management sets standards for how well tasks should be performed and must then consider the balance between competence and cost. Higher competence requires less supervision but must be weighed against the higher cost of retaining more experienced personnel. Supervisors analyze what knowledge and skills are needed by employees to perform their jobs adequately. Formal and informal job descriptions assist staff in defining the tasks their particular jobs entail.

Implementation Guidance

1. Establish formal written job descriptions to define tasks comprising the jobs/positions.
 - a. Formally analyze the tasks comprising the job.
 - b. Consider the extent to which individuals must exercise judgment.
 - c. Consider the extent of supervision needed.
 - d. Formally analyze and document the knowledge and skills needed by individuals to perform the job.
2. Evaluate the knowledge and skill exhibited by employees in performing their jobs.
 - a. Document evidence showing your employees appear to have these skills and knowledge.
 - b. Provide training opportunities for all employees, as necessary, to update and increase their knowledge and skills.

STATE OF GEORGIA ACCOUNTING PROCEDURES MANUAL

SECTION: FIVE – INTERNAL CONTROLS
TOPIC: CONTROL ENVIRONMENT

C. Management Philosophy and Operating Style

Introduction

Management's philosophy and operating style affect the way a State organization is managed, including the kinds of operating risks accepted. Management's operating style and philosophy reflect management's basic beliefs regarding how the people and activities of an organization should be managed. No one operating style is right or wrong. Therefore, management should evaluate, determine, and practice the operating style and philosophy that they believe to be most effective in their State organization. If the style and philosophy do not meet these criteria, the control environment will suffer. Once management has established an acceptable operating style and philosophy, this should be put into practice, clearly communicated, and demonstrated to the staff. Periodically, management should evaluate whether the operating style and philosophy are effective in supporting the mission and are consistently practiced. For small organizations, an informal management style might allow a face-to-face interaction, rather than written policies. A State organization's functional responsibilities will dictate the appropriate level of internal control. For example, the Georgia Department of Revenue and Department of Transportation and other large or complex agencies may need more extensive financial reporting controls than would the Sports Hall of Fame and the Golf Hall of Fame Authorities.

Implementation Guidance

1. Establish goals and policies to help achieve low personnel turnover in key functional areas such as operations, accounting, IT divisions, internal audit, as well as key management and supervisory positions.
2. Establish procedures for periodic analysis of employee turnover patterns, particularly among key financial or internal audit staff, to identify any correlation with the emphasis you place on control.
3. Establish procedures for analysis of management's attitude toward the accounting function, the reliability of financial reporting, and the safeguarding of assets.
 - a. Accounting should be viewed as a vehicle for exercising control of the organization's activities.
 - b. Management should sign off on accounting reports of results.
 - c. Valuable assets, including intellectual assets and information, should be protected from unauthorized access or use.

STATE OF GEORGIA ACCOUNTING PROCEDURES MANUAL

SECTION: FIVE – INTERNAL CONTROLS
TOPIC: CONTROL ENVIRONMENT

- d. If applicable, a cash management plan for regular reconciliation of cash received to cash deposited should be established.
 - e. Key staff should be made aware of agency and State fiscal policies and fiscal policy changes.
4. Establish a quality management initiative at each State organization.
- a. This plan should have specific goals.
 - b. All employees should be familiar with the plan.
 - c. Employees should be trained to work in teams to solve problems and improve work systems.
 - d. Management should provide leadership and quality initiative.
 - e. Work processes should be geared to specific customer needs.
5. Communication systems and procedures should be provided to allow for frequent interaction between senior management and operating management.
- a. Managers in geographically removed locations must be included.
 - b. Senior management should frequently visit decentralized locations.
 - c. Decentralized managers should visit central offices often enough to keep a broad organizational perspective.
6. Analyze and identify senior management attitudes and actions toward financial reporting and disputes over accounting treatments, such as the following:
- a. conservative vs. liberal interpretation of accounting policies,
 - b. the application of proper accounting principles,
 - c. non-disclosure of important financial information, and
 - d. manipulated or falsified records.

D. Organizational Structure

Introduction

Organizational structure provides the framework for planning and implementing objectives and maintaining internal control, therefore each organization needs to establish a structure appropriate for its mission. Senior management needs to define key areas of authority and responsibility, and establish appropriate lines of reporting. For example, the internal audit department should have unrestricted access to a senior officer who is not directly responsible for preparing the company's financial statements and has sufficient authority to ensure appropriate audit coverage and to follow up on findings and recommendations. The appropriateness of an

STATE OF GEORGIA
ACCOUNTING PROCEDURES MANUAL

SECTION: FIVE – INTERNAL CONTROLS
TOPIC: CONTROL ENVIRONMENT

agencies organizational structure depends, in part, on its size and the nature of its activities. The larger the organization, the more highly structured and formal its reporting lines will be; on the other hand, such formality might impede the flow of information in a smaller organization.

Implementation Guidance

1. Establish an appropriate, smooth flowing organization structure.
 - a. The flow of work must facilitate management.
 - b. Decentralize as much as possible.
 - c. Centralize as much as necessary.
 - d. Direct the flow of activities as appropriate upstream, downstream, or across all organizational activities.
 - e. Adjust the span of control for supervisors to an appropriate size for the supervisor, the activity, and the organization.
2. Provide key managers with adequate, written, and understandable definitions of their responsibilities.
 - a. Clearly communicate responsibilities and expectations of program activities to the managers in charge of those activities.
 - b. Provide an organizational overview to managers at all levels, so they understand how their activities tie into the goals and objectives of the entire State organization.
3. Periodically review the knowledge and experience of key managers, with respect to their specific responsibilities.
 - a. Ascertain whether managers have the required expertise, experience, knowledge, and training to fulfill their responsibilities.
 - b. Encourage managers to update their management skills as their responsibilities change.
4. Establish and maintain appropriate reporting relationships in the State organization.
 - a. Analyze the need for dual or direct reporting relationships.
 - b. Monitor the effectiveness of existing relationships.
 - c. Provide managers & supervisors with access to senior management.
5. Periodically review and modify the organizational structure to match changing conditions. Changes in the organizational structure can be affected by changes in political, regulatory, statutory, economic, technological, and/or demographic.

**STATE OF GEORGIA
ACCOUNTING PROCEDURES MANUAL**

**SECTION: FIVE – INTERNAL CONTROLS
TOPIC: CONTROL ENVIRONMENT**

6. Ascertain whether the organizational structure has sufficient numbers of employees in management and supervisory roles.
 - a. Managers & supervisors must have sufficient time to effectively carry out their responsibilities.
 - b. Establish control to ensure that non-exempt employees work only as permitted under the Fair Labor Standards Act guidelines.

E. Assignment of Authority and Responsibility

Introduction

The control environment is greatly affected when individuals recognize that they will be held accountable for their performance. Within the requirements of State laws and regulations, management must evaluate how the assignment of authority and responsibility affects employees' initiative and their ability to achieve objectives. There is a growing trend to push authority downward to bring decision-making closer to the front-line personnel. Delegation of authority or “empowerment” means surrendering central control of certain business decisions to individuals who are closest to everyday business transactions. The critical challenge is to delegate only to the extent required to achieve objectives. It is important that management ensures that all personnel understand the organization's objectives and that each individual knows how his or her actions interrelate and contribute to achievement of the objectives.

Implementation Guidance

1. Make assignments for responsibility and authority in the organization to create or assign the following:
 - a. organizational goals and objectives,
 - b. operating functions,
 - c. regulatory requirements,
 - d. information systems, and
 - e. authorizations for changes.
2. Authority and responsibility should be explicitly assigned to employees throughout the organization. Responsibility for decisions should be related to and commensurate with the delegation of authority.

STATE OF GEORGIA ACCOUNTING PROCEDURES MANUAL

SECTION: FIVE – INTERNAL CONTROLS
TOPIC: CONTROL ENVIRONMENT

3. Establish appropriate control-related standards and procedures and include them in job descriptions for applicable positions.
 - a. Keep job descriptions current for all personnel.
 - b. Amend control-related responsibilities, as they change, in the job descriptions.

4. Periodically review the size of the organization's staff in view of the following factors:
 - a. appropriate number with requisite skills in relationship to complexity of activities and systems, and
 - b. the adequacy of work force, in numbers and experience, to carry out the mission of the organization.

F. Human Resource Policies and Practices

Introduction

Through human resource policies and practices, management communicates its expected levels of integrity, ethical behavior, and competence. Hiring practices, orientation, training, evaluation, counseling, promoting, compensating, and remedial actions all influence the control environment.

It is essential that personnel be equipped for new challenges as issues that State organizations face change and become more complex, driven in part by rapidly changing technologies and/or increased regulation. For small to medium size State organizations, human resource policies may not be as formalized as one would expect in a larger entity. Whether formalized or not, these policies must be adequately communicated to all employees.

Implementation Guidance

1. Establish written policies for hiring, training, promoting, and compensating employees.
 - a. Personnel policies and procedures should result in recruiting or developing competent, trustworthy people who support an effective management control system.
 - b. Communicate the organization's expectations about the types of people to be hired and about who should participate in the hiring process.
 - c. Establish performance evaluation schedules to at least coincide with promotion and salary increase reviews. Employees need to know what is expected of them prior to advancement or promotion and the evaluation criteria should reflect adherence to standards of conduct.

**STATE OF GEORGIA
ACCOUNTING PROCEDURES MANUAL**

SECTION: FIVE – INTERNAL CONTROLS
TOPIC: CONTROL ENVIRONMENT

2. Establish procedures for making new employees aware of their responsibilities and of your expectations of them.
 - a. Employee evaluations should be done at least annually, to make sure employees are kept aware of their responsibilities and of what is expected of them.
 - b. Written communication of employee responsibilities and of management expectations can be included in job descriptions.

3. Formalize a plan of appropriate remedial action to be taken in response to departures from approved policies and procedures.
 - a. Take appropriate corrective action when established policies are violated.
 - b. Communicate to all employees, so they understand remedial consequences **will** follow ineffective performance.

4. Establish a formal procedure for adequate employee candidate background checks.
 - a. Be cautious of candidates with gaps in employment history or frequent job changes. (An exception to this rule may be in the IT area in which job changes seem to occur with great regularity.)
 - b. Investigate all criminal records.
 - c. Follow up on reference letters and contact past employers during the selection process.

**STATE OF GEORGIA
ACCOUNTING PROCEDURES MANUAL**

**SECTION: FIVE – INTERNAL CONTROLS
TOPIC: CONTROL ENVIRONMENT**

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