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Committee of Sponsoring Organizations of the Treadway Commission

COSO Internal Control Framework

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COSO ERM Framework

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2. Control Environment

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Chapter Summary

The control environment is the set of standards, processes, and structures that provide the basis for carrying out internal control across the organization. The board of directors and senior management establish the tone at the top regarding the importance of internal control including expected standards of conduct. Management reinforces expectations at the various levels of the organization. The control environment comprises the integrity and ethical values of the organization, the parameters enabling the board of directors to carry out its oversight responsibilities, the organizational structure and assignment of

authority and responsibility, the process for attracting, developing, and retaining competent individuals, and, the rigor around performance measures, incentives, and rewards to drive accountability for performance. The resulting control environment has a pervasive impact on the overall system of internal control.

Principles relating to the Control Environment component

1. The organization demonstrates a commitment to integrity and ethical values.
2. The board of directors demonstrates independence from management and exercises oversight for the development and performance of internal control.
3. Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives.
4. The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with the objectives.
5. The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives.

Principles

1. The organization demonstrates a commitment to integrity and ethical values.

Approaches

- Establishing Standards of Conduct
- Leading by Example on Matters of Integrity and Ethics
- Evaluating Management and Other Personnel, Outsourced Service Providers, and Business Partners for Adherence to Standards of Conduct
- Developing Processes to Report and Promptly Act on Deviations from Standards of Conduct

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2. The board of directors demonstrates independence from management and exercises oversight for the development and performance of internal control.

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- Establishing the Roles, Responsibilities, and Delegation of Authority of the Board of Directors
 - Establishing Policies and Practices for Meetings between the Board of Directors and Management
 - Identifying and Reviewing Board of Director Candidates
 - Reviewing Management's Assertions and Judgments
 - Obtaining an External View
 - Considering Whistle-Blower Information about Financial Statement Errors and Irregularities

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3. Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives.

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- Defining Roles and Reporting Lines and Assessing Them for Relevance
 - Defining Authority at Different Levels of Management
 - Maintaining Job Descriptions and Service-Level Agreements
 - Defining the Role of Internal Auditors

4. The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with the objectives.

- Establishing Required Knowledge, Skills, and Expertise
- Linking Competence Standards to Established Policies and Practices in Hiring, Training, and Retention Decisions
- Identifying and Delivering on Financial Reporting-Related Training as Needed
- Selecting Appropriate Outsourced Service Providers
- Evaluating Competence and Behavior
- Evaluating the Capacity of Finance Personnel
- Developing Alternate Candidates for Key Financial Reporting Roles

Principles

5. The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives.

Approaches

- Defining and Confirming Responsibilities
 - Developing Balanced Performance Measures, Incentives, and Rewards
 - Evaluating Performance Measures for Intended Influence
 - Linking Compensation and Other Rewards to Performance
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Demonstrates Commitment to Integrity and Ethical Values

Principle 1. The organization ^{fn 7} demonstrates a commitment to integrity and ethical values.

Points of Focus

The following points of focus highlight important characteristics relating to this principle:

- **Sets the Tone at the Top**—The board of directors and management at all levels of the organization demonstrate through their directives, actions, and behavior the importance of integrity and ethical values to support the functioning of the system of internal control.
- **Establishes Standards of Conduct**—The expectations of the board of directors and senior management concerning integrity and ethical values are defined in the entity's standards of conduct and understood at all levels of the organization and by outsourced service providers and business partners.
- **Evaluates Adherence to Standards of Conduct**—Processes are in place to evaluate the performance of individuals and teams against the entity's expected standards of conduct.
- **Addresses Deviations in a Timely Manner**—Deviations of the entity's expected standards of conduct are identified and remedied in a timely and consistent manner.

Approaches and Examples for Applying the Principle

Approach: Establishing Standards of Conduct

Sets the Tone at the Top

Establishing Standards of Conduct

- Establishes Standards of Conduct

Evaluates Adherence to Standards of Conduct

Addresses Deviations in a Timely Manner

Senior management, with guidance from the board of directors, defines and communicates expected standards of conduct for the organization, including any specific to those responsible for preparing external financial reporting. Such standards contain key provisions reflecting legal, ethical, and other expectations in the conduct of business and financial reporting, and articulate management's philosophy and guidance for avoiding moral hazards in the pursuit of objectives. They also leverage established professional codes of conduct, such as those associated with financial and managerial accounting, legal, information technology, or other professional organizations. To instill a common understanding of the company's standards, management develops various means for:

- Communicating and reinforcing the accountability for responsible conduct of all personnel
- Permeating standards of conduct throughout the organization, including guidelines for application to high-risk issues and geographies
- Setting the expectation that personnel raise issues or questions relating to the application of the defined standards
- Making explicit the consequences for deviations from standards of conduct at any level in the organization
- Ensuring that new and existing employees are trained on the entity's standards of conduct and continuing education, and providing appropriate briefings to third parties engaging in business with the company
- Developing performance evaluation processes and incentives (and service-level agreements as necessary) that promote the right behavior in pursuit of objectives
- Providing staff with ethics training opportunities to ensure that all employees have the knowledge to identify and deal with dilemmas

Example: Defining, Communicating, and Regularly Updating the Code of Business Conduct and Ethical Standards

The senior management of Zanzibar Co., a publicly traded company, has created, maintains, and distributes the company's code of business conduct and ethical standards to all employees and external parties acting on behalf of the company, and has posted it on the company website. The code of conduct is available in all relevant languages for ease of access and understanding by all within the global organization. The company requires all employees to complete periodic interactive web-based training sessions on various aspects of the code and ethical standards.

Furthermore, Zanzibar Co. provides a supplier code of conduct to its vendors as part of its service-level agreements, which provide a basis for evaluation alongside product/service delivery evaluation.

These documents emphasize that every individual is responsible for maintaining an ethical environment and reporting any ethical breaches. Service-level agreements and contracts with external parties include the relevant language to specify the company's expected standards of conduct and serve as a basis for evaluating adherence. The code also specifically sets out the expectation of reporting and resolving issues by providing clear information on how to ask a policy question or report a violation through an independent third party.

Senior management and the board of directors annually review and discuss any changes needed to the code or how it is administered, considering external and internal factors, including the coverage of the company's key risk areas, any known compliance issues, and results of monitoring activities. For instance, over time, Zanzibar Co. has added provisions to address new, applicable laws and has provided more guidance on what constitutes an appropriate gift or entertainment.

Approach: Leading by Example on Matters of Integrity and Ethics

- Sets the Tone at the Top
- Establishes Standards of Conduct

Evaluates Adherence to Standards of Conduct

Addresses Deviations in a Timely Manner

The CEO and key members of management at various levels in the organization articulate and demonstrate the importance of integrity and ethical values across the organization. The various forms and mechanisms used to do this may include:

- Communications from senior management that support the expected standards of conduct and that stay consistent as they permeate the organization
- Day-to-day actions and decision making at all levels of the organization that are consistent with the expected standards of conduct
- Interactions with suppliers, customers, and other external parties that reflect fair and honest dealings
- Performance appraisals and incentives that reinforce expected standards of behavior consistent with the entity's objectives at all levels of the organization
- Timely inquiries and investigations into any alleged conduct that is inconsistent with the entity's standards of conduct
- Corrective action when deviations from expected standards of conduct occur

While this approach can be synonymous with that of establishing standards of conduct when both operate effectively, history has shown instances where organizations define and communicate honorable standards of conduct, yet management does not internalize or exhibit these standards in its conduct, and therefore sets a different tone than what is expected.

Example: Using a Company Newsletter to Reinforce Expectations of Integrity and Ethics

Aerospacial S.A., a small supplier to the aerospace industry, uses its monthly newsletter to employees, outsourced service providers, business partners, and other external parties to emphasize the importance of exercising sound integrity and ethical values. Each edition of the newsletter contains a section related to ethical decision making and consequences of violations of the code. The newsletter draws attention to the multitude of resources available to discuss and resolve ethical issues; it also reports what actions are taken by senior management when the code is violated at any level of the organization. The newsletter illustrates the open dialogue and resolution of issues that is actively promoted by senior management.

Examples of ethical dilemmas are provided, along with suggested resolutions. The newsletter points out that reports of violations originate from a variety of sources, including employees, managers, the company's anonymous hotline, and external parties. Responses range from no action (in cases where the violation is shown not to have occurred) to various levels of discipline, including dismissal.

Finally, the newsletter reminds all Aerospacial S.A. employees—from senior management to entry-level—that as part of their annual performance review they must certify that they have read the company's mission statement and code of conduct and that they comply with policies at all times.

Approach: Evaluating Management and Other Personnel, Outsourced Service Providers, and Business Partners for Adherence to Standards of Conduct

Sets the Tone at the Top

Establishes Standards of Conduct

- Evaluates Adherence to Standards of Conduct

Addresses Deviations in a Timely Manner

The board of directors and senior management evaluate adherence to the company's standards of conduct. This is accomplished in a variety of ways, which may include:

- Assessing results from training and ethics certification processes
- Considering anomalies in key performance indicators and internal analytical reviews of operational and financial information that could be a potential indicator of fraudulent financial reporting or other misconduct
- Considering the results from ongoing and separate evaluations of internal control, which include evaluations of internal control at outsourced service providers and business partners who provide information necessary to produce external financial reporting
- Analyzing issues and trends from hotlines and help lines made available within the organization that could indicate potential fraud occurrences and other ethical concerns
- Requesting feedback from meetings held with outsourced service providers and business partners when obtaining financial information or information that impacts the entity's internal control over external financial reporting

Example: Conducting Ethics Audits

The not-for-profit organization Partners for Development conducts scheduled audits to determine whether employees are receiving, understanding, and applying the board-approved standards of conduct. A completeness check is performed to verify that every employee has received and attested to these standards or otherwise provided a specific explanation that is then reviewed and addressed by senior management and the board. The audits also include non-employees and consultants from the organization's IT service provider. The standards consist of three documents: the code of ethics and standards of personal conduct, the compliance policy statement, and the expected standards of conduct.

Partners for Development's purpose in conducting these audits is to determine if there are any shortcomings in understanding or instances of non-compliance and to use those findings to assess and correct any deficiencies in the organization's new-hire orientation, communications, training, and employee review processes. Upholding the organization's standards of conduct is intended to help safeguard against or escalate any instances of fraud, management override, or other illicit transactions and support complete, accurate, and reliable financial reporting to the organization's government sponsors.

Example: Evaluating Misconduct Reported through an Anonymous Hotline

All-World Food Distributors provides an anonymous hotline for employees to report potential fraud and other ethical concerns. The entity engages a third-party service provider to administer the hotline to provide the comfort of anonymity for its employees. This service immediately reports any potentially illegal acts or financial reporting improprieties directly to the company's legal department and audit committee. Issues and trends are analyzed and conclusions are reported to the audit committee of the board.

Approach: Developing Processes to Report and Promptly Act on Deviations from Standards of Conduct

Sets the Tone at the Top

Establishes Standards of Conduct

Evaluates Adherence to Standards of Conduct

- Addresses Deviations in a Timely Manner

Senior management develops and consistently follows a prescribed process and standard to promptly

investigate, report, and take action to correct any violations to the standards of conduct occurring at any level of the organization, including outsourced service providers and business partners. The process may include:

- Having individuals who are independent of the alleged matter conduct the investigation (Note, however, where the deviation is deemed significant—due to the seriousness or pervasiveness of the allegation, degree of management involvement, regulatory interest, etc.—it may be necessary to have a board-led investigation, with a special committee that is independent of management.)
- Applying criteria to prioritize deviations (e.g., monetary value, patterns, trends, reputation impact)
- Investigating occurrences of possible violations to ensure a thorough understanding of issues and circumstances
- When applicable, assessing the financial statement impact and determining what internal controls over external financial reporting may have failed to detect the matter
- Developing appropriate support documentation and reporting
- Identifying and communicating with anyone under investigation (or after thorough investigation in instances of alleged fraud), and following up on any corrective actions taken to remedy the matter in a consistent and timely basis and according to prescribed company guidelines
- Restricting access to sensitive information regarding the allegation to individuals authorized to handle the investigation
- Informing the board of deviations in the application of the standards and any waivers that may have been granted or that are being considered
- Determining how and when the violation will be communicated and if it will be made public
- Communicating to all company personnel that appropriate investigation and corrective actions have been taken
- Depending on the nature and pervasiveness of the deviation that has occurred, establishing remediation activities as needed to make retrospective corrections and forward-looking improvements

Remediation may address accounting corrections needed, process control enhancements, systems development or enhancements, accountability reinforcement, training, revisions to the standards of conduct, providing management, personnel or third parties with increased awareness of the importance of applying the standards, and other actions. The board reviews and approves the adequacy of remediation measures and progress reports.

Example: Taking Action when Deviations Occur

Best Fit Shoes has established policies and procedures to address serious improprieties or illegal acts by employees, such as theft or bribing a new supplier to secure a contract. The policy empowers the legal department to initiate the investigation together with the internal audit department or an external third party in order to understand, document, and report the facts of the alleged matter for evaluation and assessment.

Best Fit's policy clearly states that if such an illegal act or impropriety is confirmed, the company will terminate the employee, revoke all access privileges, and file formal charges with appropriate authorities. The policy also requires the human resources manager to document the situation and its resolution, analyze the root cause of the breach, and implement any additional remedial steps to avoid similar occurrences in the future. Progress reports are regularly provided to the audit committee.

During one instance, facilitation payments were made to obtain certain contracts, the policy was immediately applied, and an investigation was launched. The audit committee was notified and regularly presented with progress updates and the proposed corrective actions for approval.

Footnotes (Demonstrates Commitment to Integrity and Ethical Values):

^{fn 7} The term "organization" is used to collectively capture the board of directors, management, and other entity personnel as reflected in the definition of internal control.

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