Assessing Internal Controls:
Do Management and Staff Agree?

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OVER THE PAST DECADE, THE PRACTICE OF CONTROL SELF-ASSESSMENT (CSA) HAS EMERGED AS A KEY DIAGNOSTIC TOOL FOR EVALUATING INTERNAL CONTROLS. WHILE CSA CAN BE EFFECTIVE IN PINPOINTING AREAS OF CONCERN, THE COSTS OF SURVEYING LARGE NUMBERS OF EMPLOYEES CAN BE PROHIBITIVE. RESEARCH INDICATES THAT MANAGERS' PERCEPTIONS OF INTERNAL CONTROLS COULD BE USED AS A PROXY FOR ALL EMPLOYEES. BUT HOW RELIABLE IS THIS? THE AUTHORS UNDERTOOK AN EXTENSIVE STUDY OF FIVE FIRMS IN DIFFERENT INDUSTRIES TO FIND OUT.

An integral part of good management is to evaluate and improve internal controls (IC). Although this is required for publicly traded companies under the Sarbanes-Oxley Act (SOX), improving internal controls can enhance the operations of any organization by promoting more effective and efficient asset use, deterring fraud, and improving compliance.

Over the past decade, the practice of control self-assessment (CSA) has emerged as a key diagnostic tool that allows an organization to evaluate its own IC structure by surveying employees who work directly with or implement internal controls. Although CSA is effective in detecting and improving IC weaknesses, it carries the disadvantages of increased cost and time to administer and evaluate.

Managers face the same challenge in evaluating IC as auditors do: A complete examination of all facets of an organization's internal controls system may not be economically feasible or necessary. To complete the evaluation cost effectively, companies spend resources examining those areas of the system that are at the greatest risk for not working properly. Fast and inexpensive techniques such as analytical procedures reduce the time and cost of the IC assessment and often identify areas that may require greater (or less) scrutiny.

The aim of our study was to test whether the perceptions of top management concerning the effectiveness of internal controls are an accurate indicator of the perceptions that other employees hold and, by extension, of the general state of internal controls in the organization.

WHAT IS CONTROL SELF-ASSESSMENT?

The Institute of Internal Auditors (IIA) defines CSA as a process through which internal control effectiveness is examined with the goal of providing reasonable assurance that all business objectives are being met.[1] CSA is widely recognized as a valuable tool in gathering evidence concerning so-called "soft" controls, such as the effectiveness of internal communication and the ability to convey sensitive information between levels of management.[2] In addition, CSA provides benefits such as improving independent audits of financial statements,[3] increasing ownership of changes in IC by including those people affected by them,[4] and lowering the costs of compliance with SOX.[5]

In spite of its potential benefits, CSA is not widely used, particularly in conjunction with independent audits of financial statements. While there are a number of possible reasons for this, a common one that auditors cite is the perceived lack of efficiency concerning CSA.[6] Perhaps current research based on managers' perceptions of internal controls may provide guidance that could change that.

HOW MANAGERS VIEW INTERNAL CONTROLS

Prior research has indicated that upper management's perception of IC could be used as a proxy for the perceptions of employees at lower levels of the organization, but there is still no clear correlation.[7] If such a relationship does exist, however, organizations could benefit in a couple of key ways:

1. **Decreased investigative costs.** As with any analytical procedure, the advantage of using managers' perceptions as a proxy for employees' perceptions is that it is cheaper than surveying everyone across a large organization.

2. **Better fraud prevention.** Research in fraud prevention has indicated that the perceptions employees have concerning the effectiveness and quality of internal controls are among the best deterrents to fraud that an organization can have.[8] If management's perceptions of IC mirror those of the firm's employees, then better fraud deterrence can be achieved at a lower cost by identifying whether and where managers perceive weaknesses in IC.

Using managers' perceptions as positive indicators of effective (or ineffective) IC is more problematic. In the case of internal fraud prevention, for example, this is not as material as it might be in other circumstances because it is *employee* perceptions of effectiveness that deter fraud. As perceptions do not necessarily indicate undetected weaknesses, some substantive testing of controls always will be required. A more cost-effective indicator of weaknesses would provide substantial benefits over a shotgun approach to IC investigation in the same manner that risk-based audits have improved audit efficiency.

An added benefit of our research was to test whether upper management can attest accurately to the efficacy of an organization's internal controls. Because SOX now requires upper management to certify that the firm's internal controls are free of material weaknesses, our research can act as an educational tool that alerts managers to the strengths and weaknesses in their perceptions before they sign off on internal controls.

SETTING THE SURVEY'S PARAMETERS

The purpose of our study was to determine whether upper management's perception of the strengths and weaknesses of IC is an indicator of other employees' perceptions and, if differences were apparent, in what areas and to what degree they occur.

CSA is a well-documented methodology for internally assessing an organization's IC.[9] The most common methods of gathering information through the CSA are facilitated meetings and surveys.[10] Although both methods have advantages, surveys do not require the researchers to be present as facilitators and thus can be administered simultaneously to multiple organizations. As this study was intended to reach the largest number of firms willing to participate, we chose the survey method.

We used a previously validated CSA questionnaire that examined the five areas of IC proposed in guide-

lines issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).[11] We distributed a total of 67 questions among the five COSO categories as follows:

Section I: Risk Assessment (eight questions)
Section II: Control Activities (eight questions)
Section III: Information and Communication
 (12 questions)
Section IV: Monitoring (11 questions)
Section V: Control Environment (28 questions)

Responses followed a four-point Likert scale that ranged from 4="strongly agree" to 1="strongly disagree."

Our current research was designed as an exploratory study. We selected the firms to investigate—organizations with at least 100 employees—based on their proximity to us and their willingness to participate. Once a company agreed, we modified job titles on the CSA to coincide with the job titles in the organization. We consulted with upper management to determine which employees truly belonged to upper management and which were staff. Using a color-coded system to distinguish management from staff, we duplicated the CSA for each organization.

All of the managers identified in each organization were surveyed, but it was not possible, or appropriate, to survey all staff employees in larger organizations. Therefore, we surveyed anyone who worked in an area responsible for financial resources together with a random sample (stratified by departments) of other staff. We collected the completed surveys, each of which was anonymous, identifiable only as coming from a manager or staff.

Surveys in hand, we first calculated the average response for each question for both management and staff. Within each COSO category, we then compared the paired averages between managers and staff using a two-tailed t-test for populations with unequal variances.

The organizations we surveyed were a convenience sample and were not intended to represent all firms in the country. Given the wide variety in organizational type, we compared only management and staff within the same firm and not between firms or to the group as a whole.

A CLOSER LOOK AT WHAT WE FOUND

Six organizations that met our criteria agreed to participate in the study. All are located in the upper Midwest and come from a range of industries, including the public and private sector. The six firms eventually yielded five usable sets of data. One had a statistically significant number of "Don't know" responses, which prevented a meaningful data analysis. Table 1 summarizes

Table 1: **Demographics of Participating Organizations**

Industry	Number of Employees	Total Responses*	Manager Number	Manager % of Total	Staff Number	Staff % of Total
Retail	150	48	14	29%	34	71%
Manufacturing (pharmaceuticals)	300	30	10	33%	20	67%
Manufacturing (control systems)	556	55	18	33%	37	67%
Government	900	143	20	14%	123	86%
Insurance	1,800	195	40	21%	155	79%
Total	**3,706**	**471**	**102**		**369**	

*All employees were surveyed in organizations with fewer than 200 employees. A stratified sampling was conducted in organizations with more than 200 employees.

the organizational type, number of employees, and breakdown in the responses between management and staff for the five firms used in the analysis.

To maintain the participants' anonymity, we excluded specific names and locations. The subsequent results of the t-tests (two-tailed, unequal variance between groups) for each organization are included in Table 2, further subdivided among each of the five COSO areas.

Ironically, among the most consistent aspects of the results is the frequency with which management and staff disagreed on their perceptions of the internal controls in their organizations. Out of 25 potential areas of agreement, 17 differ to an extent that is statistically significant.

Even more striking is the nature in which management and staff employees disagree: Managers' perceptions of the effectiveness of internal controls are consistently higher than those of staff employees. Managers included virtually no comments in their

Table 2: Management and Staff Perceptions of the Strength of IC

| Internal Control Categories | Averages By Industry | | | |
	For Managers	For Staff	p-value	Significance
Risk Assessment				
Retail	3.398	3.300	0.28016	
Manufacturing (pharmaceuticals)	3.340	3.038	0.00329	**
Manufacturing (control systems)	3.201	3.092	0.42026	
Government	3.214	2.882	0.00441	**
Insurance	3.305	3.035	0.01251	**
Control Activities				
Retail	3.348	3.290	0.58590	
Manufacturing (pharmaceuticals)	3.332	3.048	0.00234	**
Manufacturing (control systems)	3.340	3.191	0.20846	
Government	3.269	2.838	0.00012	**
Insurance	3.516	3.337	0.18516	
Information and Communication				
Retail	3.435	3.256	0.00598	**
Manufacturing (pharmaceuticals)	3.124	2.915	0.01459	**
Manufacturing (control systems)	3.292	3.068	0.00608	**
Government	3.105	2.703	0.00108	**
Insurance	3.481	3.263	0.00983	**
Monitoring				
Retail	3.419	3.277	0.07197	
Manufacturing (pharmaceuticals)	3.169	2.988	0.06116	
Manufacturing (control systems)	3.304	3.028	0.00170	**
Government	2.944	2.570	0.02741	*
Insurance	3.462	3.423	0.64282	
Control Environment				
Retail	3.472	3.367	0.00782	**
Manufacturing (pharmaceuticals)	3.187	3.008	0.00219	**
Manufacturing (control systems)	3.491	3.157	0.00000	**
Government	3.402	2.943	0.00000	**
Insurance	3.572	3.345	0.00012	**

*Significant at p=.05
**Significant at p=.01

responses, but those of staff were numerous and often highly critical. Here is a sampling:

◆ "Lack of communication has been discussed so many times with no changes made that trust has been lost."

◆ "Management doesn't care about the working people; the bottom line is all that matters."

◆ "Reporting wrongdoing is futile because more than likely you'll get in trouble for it."

◆ "We're asked to produce more with fewer staff. Top management asks us to provide more information and comply with more regulations and policies, but they don't seem to associate the increased workload with the increased backlog."

◆ "We were told 'quality before quantity,' but all we hear is 'productivity, productivity, productivity.'"

Of the same 25 potential areas of agreement, there are no instances in which the average responses of staff employees are higher than those of managers. Even in cases where there is no statistical significance, managers' responses are consistently higher than those of staff.

The areas they disagree on are widely distributed. The categories of "Information and Communication" and "Control Environment" are particularly interesting. In these areas, all of the organizations not only have significant differences between management and staff, but the differences are the most widely divergent in the findings. The areas of management behavior that these two categories deal with are separate but related. The first, Information and Communication, concerns the efficacy with which management has communicated certain standards. For example, "Management has clearly communicated to me the behavior that is expected of me." The second area, Control Environment, deals with employee perceptions of organizational culture (including management integrity, competence, and fairness), with statements such as:

◆ My manager demonstrates high ethical standards.

◆ The acts and actions of management are consistent with the stated values and conduct expected of all other employees.

◆ Employees in my work unit are treated fairly and justly.

The disagreements in these two categories are troubling because they appear to reflect a disconnect between managers and their subordinates concerning both the ethical example that managers set and the ethical standards they communicate. The categories are not limited, however, to management behavior and communication. They also include whether employees have sufficient information to do their jobs, whether the organization is committed to providing quality service, and whether there are effective means of reporting and dealing with wrongdoing and improprieties. Again, in these areas, too, there was a statistically significant difference in perceptions between management and staff.

WHICH VIEW IS THE CORRECT ONE?

Overall, the results do not support the use of management's perceptions of internal controls as a proxy for the perceptions of employees at lower levels in the organization, nor do they provide evidence concerning which group is correct. A reasonable scenario could be devised to explain either set of perceptions. For example, employees may have a more limited and pessimistic outlook, or they may be better attuned to how controls really work. Conversely, managers may have a broader picture of the organization and how IC works as a whole, or they may be insulated and have an unreasonably optimistic view.

What is clear, however, is that, based on the results of our research, management and staff harbor very different perceptions of their workplace, particularly concerning the ethical environment created by management. Although the results do not necessarily indicate that organizations have poorer IC than management believes, they may be cause for concern in the context of fraud because employee perceptions of the effectiveness of fraud deterrence—as well as of organizational justice—can be strong deterrents to dishonest behavior.

Finally, although our findings were consistent and strong over a variety of organizational sizes and industries, the sample size limits them in terms of the extent to which they can be generalized. We are planning to conduct further research to expand the scope of the sample, and we would be pleased to present our results here first. ■

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ENDNOTES

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