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Unofficial translation

NBA Practice Note 1148

**Obtaining an understanding of soft controls relating
to an audit of financial statements**

Impact of culture and behaviour on the risk assessment

February 8th, 2022

Koninklijke Nederlandse
Beroepsorganisatie
van Accountants



NBA

Unofficial English translation of NBA-Practice Note 1148 *Obtaining an understanding of soft controls relating to an audit of financial statements*

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Obtaining an understanding of soft controls relating to an audit of financial statements

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1 Introduction

1.1 Introduction

The ISAs state that a working knowledge of the entity is vital for auditors. Obtaining an understanding of the culture and behaviour within the entity and the entity's governance provide an important contribution to that knowledge. The manner in which people act and deal with one another within entities is an essential factor for the entity and its continuance.

Current social developments and increased attention to culture and behaviour and dealing with ethical dilemmas mean that auditors are expected to consider the risks in these areas from a different perspective. As important aspects of culture and behaviour, soft controls are therefore a relevant element of the audit of financial statements.

1.2 Alignment with ISA 315 and the relationship between the concepts of 'culture' and 'soft controls'

When conducting an audit of the financial statements, soft controls play an important role in the internal control of the audited entity. As part of the risk assessment procedures, the auditor is expected to obtain an understanding of the internal control of the entity and conduct a risk assessment of the culture and behaviour within the entity.

Paragraph 21b of the revised ISA 315 'Identifying and Assessing the Risks of Material Misstatement' states:

"The auditor shall obtain an understanding of the control environment by performing risk assessment procedures. The auditor shall do this by evaluating whether:

- *management **has created and maintained a culture of honesty and ethical behaviour**, with the oversight of those charged with governance;*
- ***the control environment provides an appropriate foundation for the other components of the internal control system** of the entity, considering the nature and complexity of the entity, and;*
- ***control deficiencies identified in the control environment undermine the other components of the internal control system** of the entity.'*

It is therefore vital for the auditor to obtain an understanding of the culture of an entity and the behaviour of its management and employees. This may even play a role in the process of accepting or continuing an engagement.

Culture and Behaviour are broad concepts. In this Practice Note, we use the following definitions:

- **Culture** is a communal collection of standards, values and behavioural expressions that are shared among the members of the entity.¹ In other words: 'That's how we do things here'.
- **Behaviour** can be described as a collection of intentional or unintentional, (non-)tangible actions guided by nature, convictions and environment.² Behaviour comes from somewhere; something makes an individual act in a certain way. In an entity, one of these factors is the organisational culture.

There are two general visions on the interpretation of the term 'soft controls':

- 1 On the one hand, soft controls are the non-tangible factors that influence behaviour, and therefore the entities' objectives. For example, the behaviour of directors, management and employees may intentionally or unintentionally influence the preparing of reliable financial statements. 'Intangible' here means that these factors influence perceptions (and therefore behaviour), and are not always immediately visible.
- 2 Soft controls are sometimes defined as measures or instruments to influence behaviour, such as a code of conduct, whistle-blower procedures, or awareness training. These are clearly visible, and their structure and existence are relatively easy to determine.

¹ Daniëlle Braun & Jitske Kramer, De Corporate Tribe, Vakmedianet, 2015.

² Cora Wielenga, Guidance on soft controls, De Compliance Officer, 2018.

This two-part definition of the concept of soft controls may lead to confusion, however. This Practice Note does not deal with the measures used to manage or correct behaviour-influencing factors (item 2).

We will focus on the behaviour-influencing factors themselves, and how they are part of the organisational culture (vision 1).

In addition to this general principle, the Practice Note focuses on behaviour that is relevant to the audit of the financial statements to further frame the concept.

The literature does not provide a single, clear definition of the concept of soft controls. This Practice Note therefore defines soft controls as:

“The intangible behaviour-influencing factors within an entity that are important for realising the entities’ objectives”.³

This Practice Note will deal with the aforementioned (intangible) factors that influence behaviour, to the extent that they are relevant to the audit of the financial statements.

1.3 Risk assessment impact

With reference to the general objective stated in ISA 200, paragraph 17, it is important that the auditor collects sufficient and appropriate audit evidence to reduce the audit risk to an acceptable level. The auditor shall also conduct the engagements with professional skepticism, in compliance with the Auditing Standards. As stated above, culture and behaviour can influence the auditor’s assessment of the audit risk.

Soft controls may influence the operating effectiveness of controls, or ‘hard controls’⁴. It is therefore vital that the auditor obtains an understanding of soft controls within the entity during the risk assessment phase. This allows the auditor to address the risks in greater detail as the risk assessment provides a more refined understanding of the risk spectrum. Good understanding of the soft controls, together with the analysis of hard controls, will provide a more comprehensive picture of the control environment and the potential effectiveness of the controls. However, soft controls may also influence the inherent risk. If they have an effect on the inherent risk and/or the internal control risk, then it may have consequences for the detection risk. For more detailed information, see sections 2 and 6.

1.4 Objective of this Practice Note

The objective of this Practice Note is to offer the auditor concrete guidelines for obtaining an understanding of the culture, behaviour and soft controls within entities. This understanding makes a positive contribution to identifying potential risks of material misstatements in the financial statements, and to adequately address these risks through specific procedures.

Culture, behaviour and an understanding of soft controls is a complex issue, and the degree to which the auditor obtains an understanding of them requires a customised approach. The Practice Note is a guideline for the evaluation of the (effectiveness of) soft controls. This Practice Note does not prescribe a detailed fixed approach or full work program. The approach depends on the specific situation. The auditor may choose from a variety of procedures for addressing the situation, based on professional judgement.

This Practice Note is a first step in a growth model. As more experience and relevant insights are accumulated, we will develop updates for this Practice Note.

1.5 Target audience

The subject matters dealt with in this Practice Note are primarily important to auditors conducting an audit of the financial statements subject to ISA 315. Naturally, the depth and scope of the procedures

³ Kaptein and Wallage Assurance, over gedrag en de rol van soft controls: een lonkend perspectief, MAB 2010.

⁴ The terms ‘hard’ and ‘soft controls’ do not occur in the auditing standards. While soft controls deal with people’s perceptions, in practice most entities refer to hard controls when dealing with internal controls such as policies, procedures and guidelines.

may differ from entity to entity, subject to the auditors' own professional judgement. However, the contents of this Practice Note may also be relevant to auditors performing engagements other than an audit, whether they are professional accountants in public practice, internal auditors, public sector auditors or auditors in business. For example, engagements in which the (effectiveness of) internal control is important. This subject may also be relevant for compilation engagements., for example auditors who would like to use risk-oriented compilation procedures.

1.6 Reading guide / approach

This Practice Note uses certain definitions, models and techniques to consider soft controls relating to an audit of financial statements. But other definitions, models and techniques may also be appropriate.

The following topics will be dealt with in greater detail below:

- 1 Recommended procedures for obtaining an understanding of culture and behaviour. Section 2 lists the possible steps, including agreements that can be made with the audited entity.
- 2 Models for obtaining an understanding of culture and behaviour. Section 3 of this Practice Note deals with the question of how the auditor can frame culture and measure behaviour.
- 3 Techniques for analysing soft controls. Section 4 discusses the techniques the auditor can use.
- 4 Tone at the top. Section 5 explains why the auditor should pay attention to this issue, and how the auditor can do so.
- 5 Evaluation. Section 6 ties the auditor's analysis of soft controls to the assessment of the audit risk.
- 6 Reporting. Section 7 deals with reporting on soft controls.
- 7 Case study. Section 8 provides an example of a real-world case study.

Appendix 1 provides a summary of the recommended procedures for obtaining an understanding of soft controls relating to an audit of financial statements.

Appendix 2 provides a detailed description of the soft controls that are to be considered with regard to the tone at the top.

Appendix 3 provides a detailed description of 'red flags' for each soft control.

The appendices are not intended as checklists that provide a comprehensive overview, but should be considered as helpful tools.

2 Recommended procedures

ISA 315 requires the auditor to obtain an understanding of the entity. The entities' culture and the behaviour of management and employees both influence the control environment, including the relevant hard and soft controls. The auditor evaluates the degree to which the entity manages to control processes pertaining to the financial statements, and the applicable risks. Risks arise when the culture does not support the entities' goals, and because hard and soft controls are not effective. The Practice Note focuses mainly on the influence on the internal control risk. However, culture and behaviour may also influence the inherent risk. This will be discussed in more detail in section 6.

A variety of models are available for obtaining an understanding of culture and behaviour. We recommend making agreements about the use of these models with the audited entity. The auditor can discuss which aspects of culture and behaviour will be evaluated, which models and techniques will be used, how the evaluation will be conducted, and the final report format. The auditor will consider what the entity has already done in this area, especially if there is an internal audit function and/or compliance function. Based on professional judgement, the auditor will determine which aspects of culture and behaviour are important relating to the audit engagement. A soft controls behaviour model, as described in section 3.3, may support this effort and offer options for consideration.

Obtaining an understanding of soft controls may lead to the identification of deficiencies in accordance with ISAs 315 and 265, which this Practice Note refers to as 'red flags'⁵. It is also possible that obtaining an understanding of soft controls may result in identifying reinforcing elements ('green flags'). However, this Practice Note focuses mainly on identifying red flags (see also Section 6). A later update of this Practice Note may include green flags, as more experience is gained in obtaining an understanding of soft controls. The initial purpose is to obtain a better understanding of the entity in order to arrive at a more refined risk assessment. This may influence the approach to the audit, depending on the situation. One cannot say in advance whether the internal controls provide sufficient support, and what influence they will have on the risk assessment. Even if the auditor is not planning on relying on the operating effectiveness functioning of controls, then the auditor shall still pay attention to culture and behaviour. Without that an understanding, there is a chance that the auditor may not focus the substantive procedures on detecting possible errors or fraud, or is insufficiently alert to the potential of management override of controls in accordance with ISA 240, paragraph 32.

Appendix 1 offers recommended procedures. The auditor can complete this at own discretion, depending on the situation.

⁵ See ISA 265, paragraph 8 and for comparison ISA 240, Appendix 1 for examples of fraud risk factors, and the publications *Rode vlaggen Frauderisico's ontdekken en melden* editions 2020 and 2018 at accountant.nl.

3 Models for obtaining an understanding of culture and behaviour.

3.1 Introduction

The auditor may use (reference) models as the basis for the framework of standards. The social sciences offer a large number of models for culture and behaviour. It is therefore important that the auditor informs management and the those charged with governance (if applicable) about which model the auditor considers relevant and effective for the audit engagement. In the process, the auditor should also become familiar with models that may already be used within the entity.

3.2 Culture models

In addition to other factors, behaviour is influenced by the organisational culture. But behaviour also influences the organisational culture. That makes culture and behaviour important aspects of risk management. Risks arise when an entities' culture no longer supports its strategy and objectives. It is important to know the characteristics of the organisational culture and the degree to which relevant hard controls are present and effectively supported by soft controls. This means culture is a broader concept than soft controls. The organisational culture is expressed in values and behavioural standards, and encourages certain behaviour through an iterative process.

The literature offers a variety of methods and models for describing culture in detail. Some examples include:

- 1 The behavioural auditing approach⁶, which requires the collection of data to understand the underlying assumptions and mental models, such as unconscious thoughts, convictions, perceptions and emotions.
- 2 The corporate anthropology approach⁷. This differentiates between various ways of observing organisations from the perspectives of relationships, power, outsiders, time, space and cosmos, and movement.
- 3 The *Autoriteit Financiële Markten* (AFM, Netherlands Authority for the Financial Markets) currently uses building blocks as cultural elements that can have a positive effect on the organisation's performance: balanced decision-making, fair compensation and recognition, and learning from errors. This is based on insights gained from scientific research and supervisory experience.
- 4 The 'Organisational Culture Assessment Instrument' (OCAI) model by Quinn & Cameron (2016)⁸. The OCAI model differentiates between four culture types: family culture, adhocracy culture, hierarchy culture, and market culture.

Other models may also be appropriate, depending on the specific situation. The key question when choosing a model is: which one is suitable for the auditor to use for the audit and risk assessment. It is up to the auditor to determine which theoretical framework is used to describe the culture in detail and to enrich the risk assessment.

3.3 Soft controls behavioural model

The models discussed in section 3.2 are intended for identifying the organisational culture in general. This Practice Note does not deal with the various types of organisational cultures; it focuses on the question of how behaviour is influenced by employees' perceptions (soft controls) and how the auditor can pay structural attention to that behaviour when conducting an audit of the financial statements.

This Practice Note offers the example of the model by Kaptein, which consists of eight (8) types of soft controls⁹. This model has been validated and is commonly used in practice¹⁰. It is also applicable to audits of financial statements. Other models may be used as well, however.

The model by Kaptein is based on the following soft controls:

- 1 *Clarity*
Managers and employees know what is expected of them, and work with clear standards that correspond to the entities' mission and responsibilities.
- 2 *Example behaviour*

⁶ For example in the work of Jan Otten, see <https://www.behaviouralauditing.nl/>.

⁷ <https://www.leercirkel.org/wp-content/uploads/2017/04/De-corporate-tribe-van-Braun-en-Kramer.pdf>.

⁸ www.ocai-online.nl.

⁹ KPMG Acht basis soft controls 2016.

¹⁰ See <https://www.iaa.nl/actualiteit/nieuws/auditen-van-cultuur-en-gedrag-eeen-overzicht>.

Good examples encourage good behaviour, and bad examples encourage bad behaviour. What does management (and their immediate colleagues) do, and do others observe it as well?

3 **Commitment**

Does the entity encourage managers and employees to follow the desired ethics and integrity/attitude towards internal control? And are they motivated to achieve the goals to produce accurate financial statements? Or do they see it as a threat or limitation to their professionalism?

4 **Feasibility**

Are employees sufficiently supported in drawing up accurate financial statements? Are the stated goals realistic? To what extent do they put managers and employees under pressure? Unrealistic goals may force managers and employees to take shortcuts.

5 **Transparency**

Transparency refers to the degree to which managers' and employees' behaviour is visible within the entity. Do managers and employees see the effects of their behaviour, and that of others?

6 **Openness to discussion**

Can employees discuss the dilemmas they face? When entities do not talk about grey areas, a code of silence may develop.

7 **Accountability**

Are managers and employees held accountable for their behaviour? Is there room to express critical opinions?

8 **Enforcement**

Clearly intentional errors and violations of integrity are punished. Does the entity express appreciation for managers' and employees' honest behaviour?

The auditor may determine which soft controls to pay attention to. Certain soft controls may be more or less relevant, depending on the situation.

The model by Kaptein can be graphically illustrated as follows:

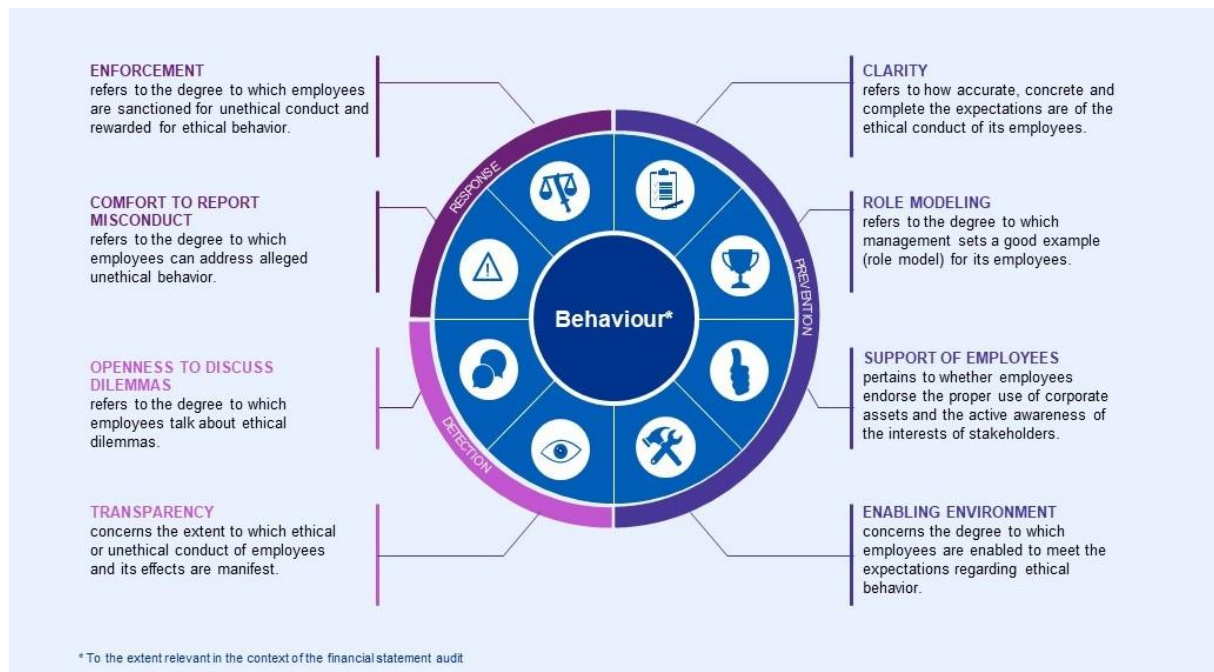


Figure 2: the model by Kaptein, with 8 soft controls

4 Techniques

There are various techniques available to analyse soft controls. The choice of which techniques to use partly determines the effectiveness and efficiency of the evaluation. Each engagement requires a custom-tailored approach. Some common techniques include conducting interviews and document analysis. These are relatively simple to perform. But the evaluation of soft controls may also utilise surveys, group discussions and behavioural observation, for example by attending meetings.

The table below is a list of some of the techniques and examples. The auditor may choose one or more of these techniques in order to obtain an understanding of the soft controls of the entity. A combination of techniques will often be more effective. It is also important that the auditor properly interprets the results and asks for clarification. This is especially important if the auditor observes a specific trend. That may depend on the validity of the techniques used. If the entity has already studied the issue, then the auditor may evaluate the results of the study and use them if relevant.

In the conduct of the audit engagement, the auditor may request the assistance of experts, including behavioural or integrity experts, to perform specific procedures relevant to the soft controls.

Techniques and examples ¹¹	
Desk research	<ul style="list-style-type: none"> • Consult existing sources to study and identify behavioural aspects. • Examples: exploratory investigation using public sources (Internet search) of potential signs of dishonest behaviour, suppliers, employee satisfaction surveys¹², culture measurements, sick leave reports, reports on compliance with the Code of Conduct, reports from second- and third-line management to directors and Supervisory Board, incident/complaint register, minutes of meetings within the supervisory body, the board and employee representation organs, as well as minutes of meetings between these bodies, employee evaluation criteria (KPIs), etc. • Check and evaluate the content of specific guidelines, descriptions, handbooks, etc. (ex. codes of conduct, whistle-blower procedures, etc.) drawn up by the entity in this context. • Check and evaluate the content of specific reports in the field of compliance with relevant frameworks (e.g. reports on compliance with code of conduct, reports by whistle-blowers, reports by internal auditor, etc.). • Examples: How does the entity publish reports on compliance with codes of conduct? How do you describe the visible active role of the boards of directors and commissioners?
Interview	<ul style="list-style-type: none"> • Ask questions to link observations from the audit of financial statements to potential 'red flags' in behaviour. • Focus on intentional and unintentional behaviour, dilemmas, choices. • Interpretation of behavioural aspects. • Example: talk with supervisors about the role of the entities' core values in realising the objectives of the department or process.
Attend meetings or group discussions	<ul style="list-style-type: none"> • Important for observations and analysis of group processes. • Look for balanced decision-making, group dynamics, peer pressure, blind spots in decision-making. • Examples: Does everyone have an opportunity to ask questions? Are they actually heard? Is it always the same people talking? Are follow-up questions asked? Are there also heated debates? How does the chairperson act?

¹¹ See also: Institute of Internal Auditors 'Discussion paper Soft Controls – *Wat zijn de aanknopingspunten voor de internal auditor?* June 2015.

¹² Employee satisfaction surveys may be useful when combined with other techniques. But employee satisfaction surveys alone are often insufficient for analysis purposes.

	When supervisors are not present, ask employees which behavioural characteristics determine the actual realisation of the objectives of the relevant organisational unit or process, dilemma session, etc.
Survey	<ul style="list-style-type: none"> • Before a targeted survey can be conducted, the auditor will first acquire knowledge of the entity and the specific question in order to determine the scope and approach. • Statistical analysis can be used to uncover connections and differences between and within groups or teams. • Examples: questions about the degree to which the employee is familiar with and acts according to the entities' core values and code of conduct; questions about the degree to which teams work together to find solutions; questions about which behavioural changes the interview subject believes are necessary.
Behavioural observation	<ul style="list-style-type: none"> • Observations during meetings and conferences. • Observations of behaviour during processes, etc., during the course of the audit. • Observe over a longer period to gain a better understanding of the usual situation. • Example: What are some clear behavioural patterns? Are there concrete examples of the soft controls within the entity (positive and negative areas of concern)? Does the entity have both qualitative and quantitative objectives? Do people think about unintended effects of highly quantitative management on the entities' objectives?

Figure 3: techniques with explanation and examples

5 Tone at the top

The tone at the top is an integral part of an entities' culture, and is mentioned as such in the revised ISA 315¹³. ISA 240¹⁴ also states that the auditor shall pay attention to the risk of management disregarding the internal control (management override of controls). Management's behaviour and attitude (tone at the top) is crucial in the auditor's evaluation of soft controls (see also previous research by NBA¹⁵).

Exemplary behaviour is an important factor for internal control. That makes the tone at the top a relevant factor for auditors to consider in the risk assessment. 'Red flags' that may indicate an increased risk relating to the audit of the financial statements are therefore essential in determining the auditor's approach to the audit.

The table below lists elements that are relevant in identifying potential 'red flags' pertaining to the tone at the top.

Soft controls	Possible questions	Possible red flags
Clarity	Is management clear about what behaviour is expected? For example: are there procedures for preparing and approving the financial statements?	Too many or too few (old) rules/standards may decrease clarity, causing employees to come to their own interpretation of what they think the standard is.
Example behaviour	Does management set a good example with regard to desirable behaviour? Is management considered to be a role model for accurate financial reporting?	Management does not visibly abide by the desired behavioural standards. Management is rigid in the compliance with standards or rules, without abiding by the 'spirit' of the standard or rule.
Commitment	Is management involved in preparing the financial statements? Do agreements with the auditor have a high priority?	Management places low value or priority on the financial statements. Management focuses on the standards, without abiding by the 'spirit' of the standards (rules/principle-based).
Feasibility	To what extent are the employees charged with preparing the financial statements sufficiently facilitated with time, training and IT resources?	Employees who prepare the financial statements in addition to their normal work, without consideration for the need for extra capacity. Too much time is set aside for preparing the financial statements, so filing requirements are not met.
Transparency	To what degree is the behaviour of management and employees visible?	The preparing of the financial statements takes place outside of management's supervision, so potential misstatements (for example in the financial statements) are not identified.

¹³ See revised ISA 315, paragraphs 21 and A106, et al.

¹⁴ See ISA 240, paragraph 32.

¹⁵ NBA discussion report *Het boegbeeld als voorbeeld*, September 2012 and NBA brochure *Auditors en Toon aan de Top*, April 2014.

Openness to discussion	To what degree is there space to discuss dilemmas that may arise in preparing the financial statements?	There is no time to discuss the dilemmas with colleagues. Employees feel unsafe.
Accountability	To what degree does management hold one another and employees accountable for (un)ethical behaviour and integrity?	Employees who do not abide by agreements for preparing the financial statements are not held accountable.
Enforcement	Is good behaviour appreciated and rewarded relating to internal control, and to what degree does management enforce the rules? Does the entity learn from errors?	Too much enforcement can lead to a culture of fear, and increase the likelihood of errors. Not enough enforcement can lead to employees creating their 'own' rules and standards. Both can increase the likelihood of errors. The entity lacks a culture of learning from errors.

Figure 5: potential deficiencies in soft controls due to the tone at the top

Based on an analysis of the tone at the top, the auditor (with or without the support of an expert) may identify deficiencies that can lead to an increased risk of the audit object containing a material misstatement.

Appendix 2 provides a detailed description of the soft controls that should be considered with regard to the tone at the top.

Appendix 3 provides a detailed description of 'red flags' for each soft control.

6 Evaluating soft controls

6.1 Introduction

When conducting an audit, the auditor will not only identify and assess the internal control environment and potential deficiencies ('red flags'), but also consider other components of the internal control system in the evaluation. The auditor will evaluate whether the control environment presents risks that need to be addressed in the audit approach. An understanding of soft controls may cause certain hard controls to be considered less effective, and therefore result in a less pronounced decrease of the internal control risk. The potential influence on the inherent risk will also be discussed below.

6.2 Impact on risk assessment and the audit approach

Relationship with the general objective

In accordance with ISA 200, paragraph 17, the auditor shall collect sufficient and appropriate audit evidence to reduce the control risk to an acceptable level, and to use the evidence to draw a reasonable conclusion upon which the auditor can base the opinion. The control risk is considered to be a function of the inherent risk (IR), the internal control risk (ICR) and the detection risk (DR). This can be formulated as follows:

$$CR = IR * ICR * DR$$

The auditor's observations of the entities' soft controls have an impact on the **internal control risk**, whereby the effectiveness of the controls can be qualified as strong or less strong as a result of the evaluation of the soft controls. This allows the auditor to come to a more refined risk assessment.

Identified deficiencies may indicate an increased internal control risk, but strong soft controls may also reduce that risk. The question is: how can the auditor show that the soft controls have supported the desired behaviour over the entire year? That requires more detailed investigation and experience. As stated in Section 2, this Practice Note only focuses on those situations involving deficiencies that result in an increased internal control risk. The control environment can influence the effectiveness of controls. Although the control environment may serve as an appropriate foundation for the internal control system, and can help reduce the risk of fraud, an appropriate control environment is not necessarily an effective deterrent for fraud. On the other hand, deficiencies in the control environment can undermine the effectiveness of controls, especially those related to fraud¹⁶.

The cultural aspects of entities, industries, branches, etc., and the employees' related behaviour, have an impact on the **inherent risk** relating to the audit. Culture is often sector-related, and the soft controls can differ between building firms, educational institutions, start-ups or companies operating in a strictly regulated environment, for example.

When evaluating the inherent risk for the audited entity, the auditor will evaluate the cultural aspects of the entity, industry, branch and the related behaviour of management and employees.

This Practice Note cannot provide a simple description of the impact that the evaluation of the soft controls has on risk assessment and the audit approach. It is the auditor's task to determine the impact on the risk assessment for each audit, and then to decide on the appropriate approach, based on the guidelines described in this Practice Note.

By obtaining an understanding of the soft controls, the accountant also gains additional understanding that is important for the risk assessment and that may have an impact on the audit approach.

The auditor is aware that the procedures focussed on evaluating the soft controls will result in different, and perhaps extra work and related documentation. Obtaining an understanding of the soft controls and reporting on them to those charged with governance will enhance and increase the impact and quality of the audit.

The auditor documents at least the following issues in the audit file:

- A description of the specific procedures that the auditor has performed or delegated in relation to soft controls.

¹⁶ See revised ISA 315, paragraphs A96-A98, A103 and A107.

- A description of the deficiencies identified in the entities' soft controls, for which the financial statements are audited;
- A description of the influence of the deficiencies on the assessment of the inherent risk and internal control risk, as well as their consequences for the (proposed) audit approach.
- An evaluation of the effect of deficiencies identified in the soft controls on the risk of management override of controls.

7 Reporting

The auditor considers whether and how to report about the soft controls as part of the reporting related to internal control. This can take the form of a management letter or perhaps in the auditor's report, for example in the key audit matters. If there are significant deficiencies in internal control, including the soft controls, then in accordance with ISA 265 the accountant shall inform management and those charged with governance.

Soft controls are often considered to be a sensitive issue, because they focus more on individuals' behaviour than on procedures/hard controls. They pertain to people's actions, behaviour and/or negligence, for example in the performance of a leadership role. Soft controls also have a less tangible nature, and it can be argued that they are not subject to an undisputed standard. It is therefore important that the auditor communicates clearly and carefully about the results of the soft controls analysis. The auditor will cautiously consider what and how to report on soft controls relating to an audit of financial statements.

Relating to an audit of the financial statements, it is important that the risk of ineffectively operating of soft controls comes to the attention of (top)management and those charged with governance, and that the topic is brought up for discussion within the entity. The operating ineffectiveness of soft controls may result in deficiencies in the control environment, and can influence other components of the internal control.

The auditor can report on observations related to soft controls, and provide concrete examples such as: violations of rules that are confusing or not realistic in practice. The auditor can then make suggestions to clarify and/or simplify the rules.

8 Case study

Situation summary

Business X is a medium-sized enterprise that has successfully built luxury villas throughout the Netherlands for years. The entity has five locations in the Netherlands in order to serve the entire national market. Each location has a single director responsible for management and serving the local market. In addition to this director, each location also has three project managers, an administration department and technical staff. The headquarters is located in Amsterdam, which houses the main office, a controller and a full back-office organisation. The locations report to the back office on a monthly basis. The main office determines the general strategy and the frameworks within which the local directors must operate. The company earns € 400 million in revenue, which has grown by an average of approx. 15% over the past few years. Last year's growth even reached 20%. However, the prospects for next year are less rosy. After-tax profits have grown along with the revenue; last year it was € 4 million, and this year is expected to reach € 6 million. The company offers profit-based compensation for the directors.

Initial risk assessment

Auditor Y has served the client Business X for several years. In the risk assessment, Y identifies an increased risk regarding the valuation of work in progress projects, especially their subjective elements, such as expectations for the projects' profitability and the progress status. The revenue accounting from the projects directly follows this valuation. Considering the nature of the projects, the results from the past few years, and the way the company is financed, Y has not yet identified any increased risk arising from limiting revenues from these projects.

Impact of risk assessment/approach:

An inherent risk for building project developers is the subjectivity of the estimation of projects' progress and expected revenue. This is an important issue for auditors. It therefore plays a crucial role in estimating the audit risk for this part of the reporting, regardless of the culture or quality of internal controls at project development organisations.

An understanding of soft controls

In this year's risk assessment, Y paid explicit attention to soft controls for the first time. Y also chose to utilise several different techniques. One of the techniques in the mix involves expanding the interviews with behavioural aspects. During the annual interview, Y also asked the controller about her experiences with the accountability culture within the entity, especially with regard to determining the value of work in progress projects, and if the controller could provide concrete examples. In the interview, the auditor learned that the controller frequently found errors in the monthly reports from one of the locations. The controller attributed the errors to the circumstance that the location's administrative assistant was having problems in his private life, and therefore had trouble concentrating on work. This was a temporary problem, according to the controller. The errors were not of a structural nature, and were always corrected quickly. Triggered by the controller's words, the auditor decided to include the location (ABC) where the employee worked in the selection of two locations to visit that year.

Impact of risk assessment/approach:

The auditor therefore estimates the internal control risk regarding the cutoff of revenue from projects as higher than that for other locations, and will use more substantive procedures (including a visit to the location and a substantive procedures of the work in progress projects) to keep the detection risk low enough to maintain the audit risk for the entire work in progress projects item at an acceptable level.

During the visit to the location, the auditor spoke to the administrative assistant and asked about the leadership style within the location, the clarity of procedures and their practical applicability. Y also asked about the employee's work load and the culture of accountability.

During the interview, Y asked for concrete examples and specifically dealt with the determination of the value of work in progress projects. The answers to these questions informed Y that the administrative assistant was unhappy with the number of errors made in the reports about work in progress projects sent to the main office. The employee was under considerable stress to meet the deadline. One of the project managers, Z, had delivered the figures for the progress of the projects

late every month for the past five months. That had never happened before. In fact, the project manager had always been the first to deliver the figures. The assistant took it in stride because the location director was of the opinion that the project manager was the location's best. The assistant understood that all too well. The director made it clear that they did not wish to hear negative comments about Z.

The interview left the auditor with a disconcerted feeling. The controller's assumption had been proven incorrect, and there may be problems with the culture and behaviour at the location. Why is Z always late in submitting reports, when they were usually the first to do so in the past? And why would the local director have such a strong reaction when this issue is brought up?

Impact of risk assessment/approach:

With the knowledge gained from the visit to the ABC location and the manner in which the central management deals with the issue, the auditor decided to pay more attention to the risk assessment for the reports on revenue from the location's projects. As a result, the auditor identified an increased risk regarding the cutoff of revenues from projects. That means the detection risk must be lowered in order to mitigate this increased risk. The auditor therefore plans to conduct more detailed work on the cutoff of revenues from projects, and will place a greater emphasis on the work in progress projects at the location involving project manager Z. The risk assessment and scheduled procedures at the other locations visited remained unchanged.

Impact of soft controls on risk assessment and procedures

The auditor initially assessed a normal level of risk regarding the cutoff of revenues from projects. In consultation with the controller and administrative assistant, however, he decided to increase the risk for this specific location, which led the auditor to expand the scope of the substantive procedures. Instead of only considering the cutoff around the balance date, Y started from the moment the reports started being delayed.

Fraudulent reporting description	Unintentional error description
<p>Through this mix of procedures, the auditor discovered that Z had shifted projects in time so that a large part of the profits were moved to the next fiscal year, when the prognoses were less rosy. Z had already exceeded his targets by the middle of the year.</p>	<p>This mix of procedures also led the auditor to discover that Z had submitted the reports in a less structured format than that prescribed by the main office. During a follow-up interview with the administrative assistant, Y learned that Z had always done so. However, with considerable effort the assistant had always been able to meet the main office's deadline. Z's work method, combined with the late submission of reports, was enormously frustrating to the assistant, but they could not bring up the issue with the local director.</p>

Verbal reporting

The auditor reported his observation to the local director, and mentioned the influence of the local director's behaviour on the administrative assistant. The local director realised that he did not take the input from the own location sufficiently seriously due to the drive to perform, which meant that the tone-at-the-top was not as it should be. The local director then implemented measures regarding Z, which Y assessed to be sufficient. The auditor considered whether the situation involved management override by the local director regarding Z, but had not collected sufficient and appropriate audit evidence to back up that suspicion. The auditor also notified the main office together with the local director.

This issue was discussed in detail during the auditor's meeting with the Supervisory Board to discuss the financial statements and the auditor's report. The Supervisory Board realised that the focus on the currently defined targets and KPIs were in conflict with the goal of obtaining reliable financial figures and the desired integrity of operations. At the same time, the board also realised that these targets and KPIs serve a business purpose. All things considered, the board asked the main office to take several steps, such as adjusting the KPIs for the main office and local directors to pay more attention to the tone at the top, exemplary behaviour and accountability. The board also expects that all key functionaries within the company should attend risk awareness training in order to raise awareness of behaviour and culture. The board will also attend these training sessions. In its supervisory role, the board will request reports

on insights into the obstructive or stimulating effects of the organisational culture and the employee's behaviour on the company's operations and those of the individual locations.

Written reporting

The auditor has included the following statement in the auditor's report. *"Our audit included the subject matter of soft controls. That means we placed even more emphasis on the behaviour and culture within your entity in our interviews with employees, to the extent that they can influence significant items or transaction flows in your financial statements. In our interviews about the determination of the value of work in progress projects, we also asked about the style of leadership, the clarity of procedures and their practical applicability, the work load and the culture of accountability. The interviews resulted in an upwards adjustment of our initial risk estimate for the proper cutoff of work in progress projects at the ABC location."*

<p>Follow-up to fraudulent reporting description</p> <p><i>"The new method for conducting substantive procedures indicated that one of the project managers at this location intentionally shifted projects in time in order to move profits to the next fiscal year. The project manager had already met his target for the current year, and wanted to ensure that he would also be considered as the best-performing project manager for the next fiscal year, where the prognoses were less rosy. We spoke with the local directors, after which the local directors implemented suitable measures regarding this project leader. Our procedures found no issues that indicate a 'management override', although the tone at the top was evaluated together with the local directors because they did not respond to the administrative assistant's reports. We recommend that you enrich the internal control with soft controls, so that any irregularities can come to light for you to address at the earliest possible stage."</i></p>	<p>Follow-up to unintentional error description</p> <p><i>"The new method for conducting substantive procedures indicated that one of the project managers at this location had been submitting project reports in an unstructured and non-standard format. We spoke with the local directors, after which the local directors implemented suitable measures regarding this project leader. Our procedures found no issues that indicate a 'management override', although the tone at the top was evaluated together with the local directors because they did not respond to the administrative assistant's reports. We recommend that you enrich the internal control with soft controls, so that any non-compliance with procedures can come to light for you to address at the earliest possible stage."</i></p>
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Appendix 1 Recommended procedures

Step	Auditing Standard
<p>The nature, extent and complexity of the audited entity determine the depth of the procedures.</p> <p>1 Organisational culture</p> <p><i>1.1 Obtain an understanding of the organisational culture</i></p> <ul style="list-style-type: none"> • Determine whether, and if so, which model will be used to obtain an understanding into the organisation’s culture type. If the audit firm has not chosen a specific model, explain the reasons for choosing the model. • Use the chosen model to determine the entities’ culture type, and document it. • Discuss with the management of the entity whether this culture type suits the entities’ expectations and the strategy it aims to follow. Document this activity. 	<p>315.21b(i)</p>
<p>2 Soft Controls that influence the control environment</p> <p><i>2.1 Obtain an understanding of the soft controls within the entity that can influence the control environment.</i></p> <ul style="list-style-type: none"> • For each unit of the entity, consider whether an evaluation of the soft controls is desirable for the audit of the financial statements, and document this consideration. Note: these organisational units will often have their own material item in the financial statements, for which a (significant) inherent risk has been acknowledged; • Determine which (academic) model will be used to obtain an understanding of the entities’ soft controls. One example suggested (but not required) in this Practice Note is the model by Muel Kaptein. If the audit firm has not chosen a specific model, explain the reasons for choosing the model. • Determine the method used to obtain an understanding of the chosen soft controls, such as a survey, interview, etc. Note: the chosen method needs to be appropriate for identifying risks for the audit of the financial statements with sufficient depth, depending on the circumstances. • Obtain an understanding of the soft controls using the chosen method (survey, interview, etc.) and document the results. <p><i>2.2 Determine which deficiencies are present in the soft controls that may indicate material risks in the financial statements (‘red flags’).</i></p> <ul style="list-style-type: none"> • Based on the auditor’s professional judgement, determine whether the soft controls are insufficient because there are too many or not enough (red flags). Document this assessment. This Practice Note provides examples of red flags pertaining to tone at the top/leadership style. <p><i>2.3 Determine the potential influence that the deficiencies in the soft controls may have on the other elements in the control (environment).</i></p> <ul style="list-style-type: none"> • Determine the potential influence that the deficiencies in the soft controls may have on the elements in the control environment or other controls, and document the findings. The auditor may come to the conclusion that the deficiencies in the soft controls extend beyond the audited organisational unit or units. The auditor I therefore needs to conduct a broader evaluation of the potential influence of the deficiencies. 	<p>315.21b(ii)</p> <p>315.21b(iii)</p> <p>315.21b(iii) 315.27</p>

Step	Auditing Standard
<p>3. Evaluate the ‘red flags’</p> <p><i>3.1 Determine the potential impact of the red flags identified on the financial statements.</i></p> <ul style="list-style-type: none"> Evaluate whether the identified red flags could lead to a material error in one or more items in the financial statements, or may have a broader effect on the accuracy of the financial statements, such as the ability of the entity to continue as a going concern. This evaluation should not consider the internal controls (gross evaluation). Document the results of this evaluation. <p><i>3.2 Document the audit approach, taking identified red flags into consideration.</i></p>	<p>315.28</p> <p>330.6/7</p>
<p>4. Reports</p> <p><i>4.1 Determine which red flags indicate a significant deficiency in the internal control.</i></p> <p><i>4.2 Report the significant deficiencies to the supervisory body in a timely manner.</i></p>	<p>265.8</p> <p>265.9</p>

Figure 6: sample procedures

Appendix 2 Questions regarding soft controls

8 identified soft controls (Kaptein model)	Sample questions for obtaining an understanding	'Red flags' for potential risks (not exhaustive list)	Documents the auditor can use to gain an understanding (not an exhaustive list)
Clarity	<ul style="list-style-type: none"> To what degree is management able to explain the main risks relating to creating and maintaining a culture focused on ethical behaviour and integrity? How and to what degree does management pay attention to the duties and responsibilities related to creating and maintaining a culture focused on ethical behaviour and integrity? Is management clear about what behaviour is desirable when preparing the financial statements? Is management clear about the procedures for preparing and approving the financial statements? 	<ul style="list-style-type: none"> Employees often consult with colleagues in the performance of their duties. Rules are lacking or obsolete. Employees don't know where the relevant policy is documented. Employees have difficulty interpreting the rules. Rules overlap or are contradictory. Employees do not make operational decisions that their work sometimes requires. Management invests little time and shows little interest in explaining the rules. Management does not check whether employees have properly understood the rules. 	<ul style="list-style-type: none"> The entities' risk assessment. Describe duties and responsibilities related to financial reporting. Training materials.
Example behaviour	<ul style="list-style-type: none"> To what degree is management's behaviour and attitude suitable to the entities' core values and objectives? How does management's attitude/behaviour correspond to the desired implementation of the control environment? Is management considered to be a role model for accurate financial reporting? 	<ul style="list-style-type: none"> Employees complain about the board or their immediate supervisor/manager. Role models don't comply with applicable rules. Management speaks a different language than employees. 	<ul style="list-style-type: none"> Describe management attitude and behaviour in a competency profile, for example; Code of conduct, incl. evaluation of compliance. Management contribution to internal training courses and sessions. Annual evaluation of management performance.
Commitment	<ul style="list-style-type: none"> How does management show commitment to compliance with written and unwritten rules pertaining to ethical behaviour and integrity? To what degree does management intervene in situations where compliance with written and unwritten rules pertaining to ethical behaviour and integrity is under threat? Is management involved in preparing the financial statements? Do agreements with the auditor have a high priority? 	<ul style="list-style-type: none"> Management is not aware of the relevant rules. Management does not attend meetings. Management does not ask questions at meetings. Management does not intervene when something goes wrong. Management is not willing to invest in the right tooling/systems for employees. People sometimes ask: 'why are we doing this?' Long working hours. Extra hours. 	<ul style="list-style-type: none"> Employee satisfaction survey. Risk management reports. Annual evaluation of management performance.

8 identified soft controls (Kaptein model)	Sample questions for obtaining an understanding	'Red flags' for potential risks (not exhaustive list)	Documents the auditor can use to gain an understanding (not an exhaustive list)
		<ul style="list-style-type: none"> • Long reports to ensure that all issues are dealt with in detail. • Micromanagement. 	
Feasibility	<ul style="list-style-type: none"> • To what degree does the entity possess sufficient and capable people and adequate (IT) systems that are suitable to the entities' objectives and for the preparing of the financial statements? • To what extent are the goals set by the entity realistic? 	<ul style="list-style-type: none"> • Long working hours. • High number of sick employees. • High number of errors. • Wrong priorities. • Lack of quality equipment/IT systems, compensated by extra work hours and manpower. • Many malfunctions in supporting equipment/IT systems. • Optimistic work load estimates. • Self-satisfaction. • Wrong team composition. • People complain about lack of effectiveness. 	<ul style="list-style-type: none"> • Recording employee evaluation interviews. • Sick leave statistics. • Number and duration of open audit findings. • Employee satisfaction survey
Transparency	To what degree is the behaviour of management and employees visible?	<ul style="list-style-type: none"> • Invisible projects. • Reports only known to the boss. • Learning areas are not shared. • Too much information. • Less focus. • A culture where everyone copies everyone else. 	<ul style="list-style-type: none"> • Management reports on the effectiveness of control measures. • Internal/external audit reports. • Incident reports (ex.: whistle-blower reports). • Employee satisfaction survey
Openness to discussion	<ul style="list-style-type: none"> • To what degree are transparent results and dilemmas brought up for discussion when preparing the financial statements, and does management make room for an open discussion? • To what degree do employees experience and utilise the space to discuss a culture of ethical behaviour and integrity? 	<ul style="list-style-type: none"> • Dilemmas are seldom or never acknowledged. • People¹⁷ are blamed for being critical. • Difficult dealing with opposing opinions. • People focus on their own responsibilities and not on the entities' objectives. • Meaningless discussions. • Never reach a conclusion. • No clear focus on what really matters. • No executive action. 	<ul style="list-style-type: none"> • Minutes of board meetings, team meetings and day starts. • Employee satisfaction survey
Accountability	<ul style="list-style-type: none"> • To what degree does management hold one another and employees accountable for (un)ethical behaviour and integrity? • To what degree can employees bring things up for discussion? 	<ul style="list-style-type: none"> • People keep their heads down. • Few incident reports. • Hesitance to speak up. • Difficult dealing with opposing opinions. • People experience rules as simple check-the-box exercises. 	<ul style="list-style-type: none"> • Recording employee evaluation interviews. • Employee satisfaction survey

¹⁷ Where this overview uses the term 'people', it implies both management and employees.

8 identified soft controls (Kaptein model)	Sample questions for obtaining an understanding	'Red flags' for potential risks (not exhaustive list)	Documents the auditor can use to gain an understanding (not an exhaustive list)
	<ul style="list-style-type: none"> To what degree is it possible to challenge management? 	<ul style="list-style-type: none"> People avoid contact or keep a low profile. Every trivial incident is discussed at length. 	
Enforcement	<ul style="list-style-type: none"> To what degree does management enforce the written and unwritten rules pertaining to ethical behaviour and integrity? To what degree do employees take advantage of the opportunity to contribute to the enforcement of integrity violations and sanctioning undesirable behaviour? To what degree does management appreciate and reward compliance with written and unwritten rules pertaining to ethical behaviour and integrity? To what degree do employees contribute to rewarding and/or sanctioning management and employees for (violations of) ethical behaviour and integrity? 	<ul style="list-style-type: none"> 'Wild west'. No one follows the rules. No one is punished. Afraid to express opinions. People are demotivated. Excessive enforcement, fines and punishments. High percentage of employees leaving the company. Repeated errors. 	<ul style="list-style-type: none"> Internal/external audit reports. Whistle-blower procedures. Employee satisfaction survey

Figure 9: elements of soft controls from management's perspective

Appendix 3 Red flags for each soft control

1 Clarity

There are two extremes to the spectrum of clarity. In the optimal situation, an entity ensures that employees are clear about what is expected of them. In that case, the standard is clear. Good communications are crucial in that respect. There are two extremes on the organisational communication spectrum. Not enough communication results in a situation of 'normlessness'. Too much communication creates 'paternalism' within an entity.

Normlessness

Employees will create their own standards if there is a lack of communication. That can lead employees to intentionally or unintentionally deviate from the desired behaviour. For example: if the internal accounting policy for estimates does not provide enough guidance, then the item may be presented as too low, which results in profits that are too high. It may then incorrectly fall within the limits of the bank covenant, causing a user of the financial statements (such as a bank) to incur risk.

The same also applies to the effectiveness of controls. Here, too, the question is how clear the standard is to the person implementing a control. For example: are the standards clear for management expense claims or VAT?

Paternalism

Sometimes entities can over-regulate activities, negating the purpose of the regulations. Following the rule becomes a goal in and of itself. As a result, employees stop thinking and interpret everything in a rule-based manner. Expense claim rules describing every imaginable scenario can prove to be excessively complex and unworkable. That increases the likelihood of errors.

2 Example behaviour

People watch each other, learn from each other, and follow others' examples. But do we also communicate the intent behind the behaviour displayed? The more people set a good example, the more others will display the desired behaviour within the entity.

There are two extremes on the organisational example behaviour spectrum. If the example behaviour is not the desired behaviour, then it will generally destabilise or undermine the entity. But if the example behaviour is exaggerated, it can be perceived as aggressive or dominating.

Undesirable example: no clear example behaviour

Those responsible for determining the entities' direction do so in a way that does not achieve the entities' strategic goals. For example by displaying behaviour that does not attain the level the entity defines as 'ethical'. For example: not abiding by agreements, or acting in conflict to agreements; ignoring internal agreements (they apply to the rest of the entity, but not to me).

Result: the undesirable behaviour percolates through the entity, and is copied by managers/employees at lower echelons. Employees at lower echelons hide behind 'the boss'. Instructions are not followed, or employees wait to see how the instructions are enforced before following them. This confusion exacerbates uncertainty and increases the likelihood of errors within the entity. If a bad example is not in tune with the employees' internal standards/ethical conscience, then it will undermine their respect for the manager. That leads to mistrust and increased risks within the entity, for example through non-compliance with instructions. Theoretically, you could still rely on the described control environment, but in practice the instructions are implemented differently.

Undesirable example: example behaviour is too dominant

If the example behaviour is exaggerated or inauthentic, then employees may feel that they are only doing their work well if they work exactly according to the example. They may feel that there is no room for minor errors, independent thought is not appreciated, and that the company line is imposed draconically from above.

The example behaviour results in a pattern where employees interpret everything according to the rules, and are hesitant to think or act for themselves. Dissent not appreciated. The lack of opposing opinions discourages employee involvement. That leads to lack of a sense of responsibility, and management is not held accountable for potential risks to the entity in a timely manner. Instructions

are carried out based on a dominant leader's personal vision, even if it deviates from described instructions for the desired implementation of the control environment.

3 Commitment

Ethical behaviour within an entity not only depends on the degree to which employees know what is desired (clarity and example behaviour), and can follow it (feasibility), but also the degree to which they are motivated to do what is desired of them: commitment.

The degree to which employees feel committed to the policy can influence the employees' behaviour. Do all employees, including management, feel loyal and connected to the entity and its goals? Is there mutual trust between employees and management? Do employees, including management, see changes as opportunities, instead of threats?

Research has shown that when an entity shows employees more respect and involves them in decision-making, it leads to a higher degree of integrity among employees.

In an optimal situation, employees and management are committed to the entity and its policy and objectives. However, if there is too much commitment, or not enough, it can result in threats and undesirable situations.

Too much commitment

Too much commitment can lead employees to interfere with tasks that are not their responsibility, and for which the employee does not have the necessary competencies. Over-committed employees often cannot deal with criticism and are more difficult to manage, which increases the risk of undesired behaviour. And employees taking on work for which they have not acquired the right competencies can increase the likelihood of errors.

Not enough involvement

Employees who are not sufficiently committed to the entity feel less inclined to follow the existing rules, guidelines, standards and values. This lack of commitment increases the risk of non-compliance with rules and guidelines and of undermining control measures, which increases the likelihood of intentional or unintentional errors.

4 Feasibility

Are the stated goals, duties and responsibilities realistically feasible? To what extent do they put managers and employees under pressure? Unrealistic goals may force managers and employees to take shortcuts. The more people who possess the necessary knowledge and expertise, the better able they will be to do what is expected of them.

Feasibility deals with the question of whether:

- 1 the duties, objectives and responsibilities have been formulated realistically. And if so, then:
- 2 are there enough people available to implement them;
- 3 are these people properly qualified, and do they possess the necessary knowledge and expertise;
- 4 do these people have enough time to accomplish their tasks; and
- 5 do they have the right tools and resources?

There are two extremes on the organisational feasibility spectrum. If employees are not sufficiently facilitated in the above, then they face a situation of scarcity. But if the above facilities are abundant, the supply may be excessive. Both options can present certain risks.

Undesired feasibility: scarcity

In this situation, the duties, objectives and responsibilities are not realistically feasible because:

- 1 there are not enough people to conduct the activities;
- 2 the people are available, but they are not sufficiently qualified and do not possess the necessary knowledge and expertise;
- 3 there is not enough time available to conduct the activities;
- 4 the people do not have enough of the right tools and resources, or the time, tools and resources are not suited to realising the objectives and responsibilities.

As a result, the employees are under increased pressure, which presents the risk that employees will take shortcuts to achieve the goal. This in turn increases the risk of intentional or unintentional errors. If the entity does not consider the need for knowledge and expertise in general, employees will tend to assume each other's responsibilities; colleagues take over tasks because others do not have time and a decision needs to be made.

Potential consequences/risks: decisions made quickly, without (sufficient) justification, by people without the necessary knowledge, incomplete collection of evidence, an understanding and overview due to lack of tools and resources, etc.

Undesired feasibility: abundance

The other end of the spectrum is the situation of abundance. In this situation, the duties, objectives and responsibilities are not realistically feasible because:

- 1 the activities are conducted by too many people, leaving time to interfere with others' duties and responsibilities; the team becomes stuck in details, and cannot limit their attention to the core issues;
- 2 employees are overqualified, with the potential consequence that every task is made more complex than is necessary or desired;
- 3 there is more time available than necessary, with the result that employees look for other ways to fill their time or take on activities unrelated to the task at hand, which presents the risk of duplication, confusion and/or overlapping roles. This in turn can lead to the wrong decisions being made (at the wrong level, or by the wrong people);
- 4 an abundance of tools and resources shifts the focus to 'gadgets' instead of the content and conduct of the work. It is also possible that employees have difficulty choosing which tools should be used for the task. Employees are not challenged, and their learning ability declines.

5 Transparency

Transparency is a requirement for detecting and correcting errors and/or fraud in the draughting of the financial statements. It is only possible to identify undesirable behaviour, errors or fraud if they are visible. The more clouded, obscure or vague the process or department is, the more likely it is that employees will follow their own principles unchecked. This may deviate from the entities' standards. That presents the risk of unethical behaviour or carelessness.

There are two extremes on the organisational transparency spectrum. If there is not enough transparency, then behaviour is unobservable. But if everything is transparent, then the entity runs the risk of over-reporting. Both have a negative effect on behaviour, and therefore on controlling the (financial reporting) risks. During the audit of the financial statements, the auditor will pay attention to the red flags described below.

Invisibility

The likelihood of errors and/or fraud not being detected increases as transparency decreases.

Possible indicators include:

- complex organisational structures or processes;
- auditor surprised by findings that have played a role for some time;
- management reports are missing, outdated or incomplete;
- extremely limited control information in the form of formal reports, for example;
- no initiative to measure employee sentiment;
- board, management or internal audit staff are surprised or notified too late;
- results of activities, projects or change processes are not shared with the employees.

Overreporting

Entities occasionally become too enthusiastic about transparency and overwhelm the entity with information. The assumption is that 'if I keep my colleagues informed, then they'll be just as responsible as I am', which results in no one actually assuming responsibility.

Possible indicators include:

- abundance of reports;
- highly detailed reports;
- everyone included in the CC;

- approval is required for every decision;
- many people attending meetings, without a clear reason;
- a plethora of KPIs, dashboards, etc.

6 Openness to discussion

Openness to discussion helps employees correctly interpret the written and unwritten rules within entities. If an entity does not discuss rules and standards, employees may be unaware of (unwritten) rules, or interpret and apply them incorrectly. This can lead to (unintended) undesirable behaviour or errors that have consequences for reporting. The auditor will ask whether and how employees share dilemmas and errors. Do employees feel completely free to share dilemmas? Are supervisors willing to listen to dilemmas, or do they tend to ignore problems?

For example: if an employee is unaware that there are guidelines for how the employee is expected to assess the risk regarding the valuation of inventory (obsolescence), and does not discuss it with colleagues and/or management, then it is highly likely that the valuation will be incorrect. In the financial statements, this can lead to an incorrect statement for the inventory item. Discussing these (unwritten) rules within entities can ensure that employees are always aware of the desired behaviour.¹⁸

There are two extremes on the organisational openness spectrum. On the one hand, because entities create a culture and atmosphere where almost nothing can be brought up for discussion, and management tolerates absolutely no dissent. In these situations, employees toe the line and keep important dilemmas and innovative ideas to themselves. This creates a situation of underexposure.

The other extreme is a culture in which employees frequently have discussions about every imaginable issue. Every detail is discussed with the employees, and sometimes the same issue is discussed multiple times. That can be interpreted as a sign of indecision, and result in a lack of ownership and effectiveness. Both have a negative effect on behaviour, and therefore on controlling the (financial reporting) risks. During the audit of the financial statements, the auditor will pay attention to the red flags described below.

In addition to the degree to which employees discuss (unwritten) rules within entities, another important aspect of the soft control 'openness to discussion' is the space available to have such discussions. Entities that do not offer space to discuss problems or dilemmas with one another (no space for dissent or alternate opinions) may be more likely to develop problems than those that do offer such space. On the other hand, an excessive culture of meetings within entities can inhibit the entities' decisiveness and flexibility. These entities will hold frequent meetings that result in relatively few decisions being made.

Underexposure

Entities are more likely to make errors or not achieve objectives as employees feel less free to discuss issues with one another or to bring innovative ideas and dilemmas to management's attention.

Possible indicators include:

- employees do not share problems/dilemmas within the entity with colleagues or supervisors; people withdraw to form smaller groups. Employees do dare to speak out after problems arise ('I could have told you that').
- Supervisors tolerate no dissent, and do not bring dilemmas up for discussion themselves or ask employees about potential problems or bottlenecks;
- reports about the entities' performance (such as the auditor's letter to management) are heavily criticised for their findings, and reports are only grudgingly accepted, if at all;
- no structural or period meetings between employee representatives, the entities' management and the supervisory body. Or if there are such meetings, they only deal with facts or operational issues; the dialogue is awkward and does not take place in an open, transparent atmosphere;
- direct contact between the supervisory body and the entities' employees is obstructed by management (backroom dealings);
- if employees are not consulted for any reason, it can lead to dissatisfaction;

¹⁸ This example can also be used for the subject of clarity. Issues are often interrelated or overlapping, which emphasises the importance of effective and structured intervention.

- when asked, several employees refer the auditor to other colleagues without providing the relevant information ('the runaround'). Eventually, the auditor will have to speak to the entities' management.

Indecision/excess communication

Some entities go overboard in their openness for discussion and talk endlessly about issues without taking action. Possible indicators include:

- high frequency of meetings that do not result in decisions or to-do lists;
- taking a long time to make decisions and involving large numbers of employees in the decision-making process;
- employees discuss every detail of issues at hand without focusing on specific issues;
- many decisions are unnecessarily submitted to the supervisory body for approval;
- the supervisory body, management and/or employees devote considerable time and effort to meetings;
- if employees are not consulted for any reason, it can lead to dissatisfaction;
- when asked, several employees refer the auditor to other colleagues without providing the relevant information ('the runaround'). Eventually, the auditor will have to speak to the entities' management.

7 Accountability

The possibility of holding one another accountable within an entity is mainly important for promoting desirable behaviour. Accountability therefore largely determines internal controls that deal with following procedures and guidelines. This soft control is especially effective at detecting discrepancies that may not be immediately visible to the entity or auditor.

Accountability reinforces controls when someone in a system grants approval when the control was not actually conducted, or when passwords are shared.

Holding one another accountable for behaviour promotes a sense of security among employees. The safer they feel reporting discrepancies or holding others accountable within the entity, the more they will actually do so, and the more the entity will learn from the experience. In addition to feeling secure at work, holding employees accountable for one another's behaviour is also a skill that differs from person to person, and one in which the entity can invest time and resources.

There are two extremes on the organisational accountability spectrum. On the one hand because an environment is created where holding one another accountable for discrepancies is not tolerated or has no effect. That creates a sense of insubordination or indifference. The other extreme is a culture in which employees hold one another accountable for every minor discrepancy. This can be perceived as excessive interference. Both have a negative effect on behaviour, and therefore on controlling the (financial reporting) risks. During the audit of the financial statements, the auditor will pay attention to the red flags described below.

Insubordination or indifference.

The likelihood of errors and/or fraud not being detected increases as employees feel less freedom to hold one another accountable, and avoid doing so. Possible indicators include:

- supervisors who do not appreciate feedback ('one way – my way'), or who listen to employees and then ignore their input. The first creates a culture of fear, while the second encourages a laissez-faire attitude.
- frequent and heated discussions between the auditor and supervisors regarding the audit findings, or accepting the auditor's findings without comment or follow-up. In the first situation, the auditor's reports are edited and revised until they no longer contain important areas of concern. In the second, reports are skimmed, rather than read prior to acceptance;
- management reports show how well the entity performs, but repeatedly include the same areas of concern;
- there is no room for initiative or flexibility in procedures, or the entity makes too many exceptions ('that prove the rule');
- parroting one another/no dissent;
- little diversity/same backgrounds;
- little turnover within the department staff.

Interference

Some entities can go overboard with accountability, and everyone has an opinion on how ‘things should be done’. Possible indicators include:

- slow decision-making or reporting processes;
- involvement of many employees/departments in decision-making and/or reporting processes;
- overly detailed reports;
- many adjustments to procedures and guidelines;
- (lack of) clarity about procedures and guidelines;
- authorisation required to do anything;

8 Enforcement

Enforcement involves imposing consequences on noncompliance with agreed-upon rules, standards and values.

Imposing sanctions or granting rewards help to reinforce the norm and the policy. Some options include financial or non-financial rewards, such as granting employees more responsibility and authorisation to make decisions.

Clear violations of integrity or undesirable behaviour are sanctioned, and desirable behaviour is appreciated and rewarded. Does the entity express appreciation for managers’ and employees’ honest behaviour? The more effective the enforcement is, the more people will tend to seek rewards and avoid sanctions.

The level of enforcement influences employees’ behaviour.

In an optimal enforcement situation, employees will abide by the agreed-upon rules, standards and values in order to achieve the entities’ objectives. However, if there is too much enforcement, or not enough, it can result in threats and undesirable situations.

Too much enforcement

Too much enforcement can lead to oversensitivity among employees, discouraging them from expressing their thoughts and making them demotivated. This poses the risk of undesirable behaviour and a high percentage of employees leaving the entity, which makes intentional and unintentional errors more likely.

Not enough enforcement

Not enough enforcement will lead employees to violate the agreed-upon rules, standards and values. Non-compliance goes unpunished, existing rules and guidelines are ignored and internal control measures are undermined. This tolerance can lead to a ‘wild west’ situation where employees have their ‘own’ rules and standards, which makes intentional and unintentional errors more likely.

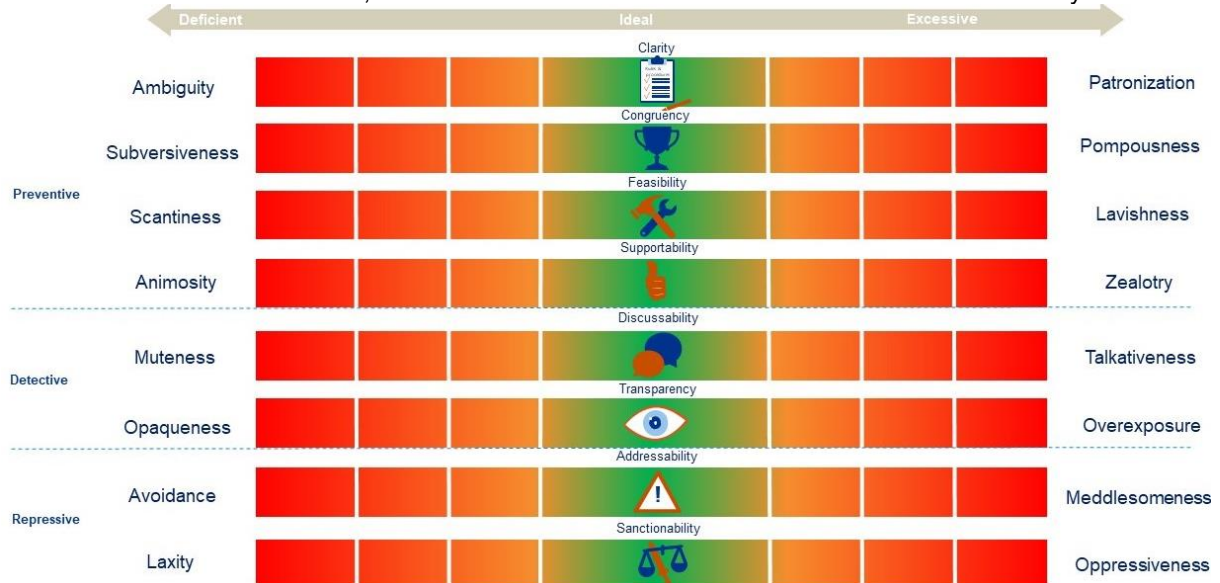


Figure 10: sample schematic diagram

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