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Review

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# CONTRIBUTION OF THE CONTROL ENVIRONMENT TO SUCCESSFUL CHANGE MANAGEMENT

**Summary:** *The aim of this paper was to demonstrate, through an overview of numerous studies conducted worldwide, that there is a positive correlation between the control environment and the success of change management. By synthesizing the findings of a large number of authors and studies, it was shown that a strong control environment has a significant impact on the quality of internal control systems, as well as on the organization's approach to risk management, including those related to change. This contribution depends on the type of organizational culture. If the culture is flexible, adaptable, based on open communication, teamwork, learning from mistakes, continuous improvement, and adequate leadership, organizational cultures can facilitate and encourage acceptance of change; otherwise, they can be a significant obstacle to successful change management. The conclusion of this paper is that the control environment represents an extremely important and specific set of resources that can greatly assist organizations in their efforts to quickly adapt to changes in the internal and external environment and achieve their goals. Relying on the control environment is in line with the approach of 'effectuation,' which assumes that changes should not be viewed as risks to be avoided at all costs, but as opportunities that can be utilized based on existing resources, such as the control environment with all its elements. By creating a culture that values risk management, organizations can better manage change and protect their employees, customers, and other stakeholders.*

**Key words:** *change, risks, control environment, organizational culture, effectuation*

**JEL classification:** *M14, M19, M49*

## INTRODUCTION

The world we live in is characterized by increasingly fast, uncertain, complex, and ambiguous changes. Existing management models and approaches also need to change and adapt to new circumstances. Numerous authors have dealt with the issue of changes and how to manage them (Schaffer and Thomson 1992; Abrahamson 2000; Gilley and Maycunich 2000; Cope 2003; Hansen and Kontoghiorghes 2004; Denning 2005; Gilley and McMillan and Gilley 2009; Năstase and Giuclea and Bold 2012). One approach is to focus on goals/effects and attempt to provide the resources needed to achieve those goals. Another approach, known as 'effectuation,' starts with the existing resources that every organization has and then tries to achieve the best possible effects based on them (Sarasvathy 2001). Based on the effectuation approach, this paper considers the control environment as one of the increasingly significant resources that can contribute to managing changes and the risks that accompany them.

It is widely accepted in both literature and practice that a control environment is necessary for the successful implementation of internal controls (Supriyanto and Deden and Mohd Haizam and Obsatar 2021; Liu and Nie and Huang 2018), and that internal controls are essential for successful management and achievement of organizational goals. Many authors have shown in their research the existence of a positive correlation between the control environment (organizational culture) and business performance (Flamholtz 2001; Sackmann 2011; Graham and Grennan and Harvey and Rajgopal 2022; Waal 2010, Shahzad et al. 2012; Xiaoming and Junchen 2012; Owoyemi and Ekwoaba 2014). Some researchers have examined the relationship between the control environment / organizational culture and successful change management (Rashid and Sambasivan and Rahman 2003; Schein 2003; Hansen and Kontoghiorghes 2004; Mosadegh Rad 2006; Daft 2008; Cameron and Quinn 2011; Uzkurt and Kumar and Kimzan and Eminoğlu 2013; Naranjo-Valencia and Jiménez-Jiménez and Sanz-Valle 2016; Bernardes et al. 2020). All of them agree that an organization's ability to adapt to changes largely depends on its organizational culture, and that organizations with a developed, flexible, and adaptable organizational culture manage changes more successfully and achieve better business results.
In her previous research, Stojanović pointed out that the levels of knowledge, experience, interest, and awareness in Bosnia and Herzegovina are not at the level necessary to understand the importance of the control environment and give it due attention (Stojanović 2020). The basic assumption of this research is that the control environment / organizational culture represent a significant set of resources that are crucial for successful change management. Therefore, the aim of this paper was to show, through a synthesis of research conducted worldwide, that there is a positive correlation between the control environment, i.e. organizational culture and the success of change management, and that a strong control environment can greatly help organizations to quickly adapt to changes in their internal and external environment and achieve their goals.

## 1. RESEARCH METHODOLOGY

In order to test the hypotheses, the author of this paper applied standard scientific methods such as description, analysis, and synthesis, inductive and deductive methods, abstraction and concretization, as well as the method of comparison.
While performing the desk research, the author analysed relevant literature in the areas of internal controls, control environment, organizational culture, risk management, and change management; relevant scientific research and studies, as well as other sources that are directly or indirectly related to the topic of the paper. Based on comparative analysis and synthesis of all collected sources, the author was able to reach general conclusions regarding the defined hypotheses and objectives.

## 2. RESULTS AND DISCUSSION

### 2.1 The role and significance of the control environment

Given the ever faster and more intense changes, increasing business complexity, more rigorous legal requirements, shareholders' expectations, demands for preventing irregularities and frauds, and the need to protect the organization's assets and resources, a high level of transparency and control is imperative. Internal controls ensure that business processes are organized and executed in a way that minimizes risk and ensures the integrity of operations. They ensure compliance with operating standards and legal requirements, reducing the possibility of abuse and fraud, and minimizing the risk of loss of assets and resources. To be successfully applied, adequate control environment is necessary for internal controls. This means that the control environment is a key factor that enables internal controls to be applied properly, and successfully manage risks to achieve the organization's goals.

International Standards for the Professional Practice of Internal Auditing define the control environment as "the attitude and actions of the board and management regarding the significance of control within the organization" (IIA 2016, 29). The control environment provides the discipline and structure necessary to achieve the primary objectives of the internal control system and consists of: integrity and ethical values; management philosophy and operating style; organizational structure; assignment of authority and responsibility; human resource policies and practices; and staff expertise. Control environment represents a broader framework that encompasses organizational culture, policies, procedures, and practices that influence the way an organization is managed. According to the COSO Enterprise Risk Management (ERM) framework, management and culture are one of the five key elements of the model that contribute to establishing an effective risk management process in the organization.

The relationship between the quality of the control environment, internal controls, risk management, and business performance has been the subject of numerous studies. Although economists traditionally argued that differences in firm performance stem from production inputs, individuals have recently begun to point out that the greatest differences in success among firms should be sought in the invisible forces that exist within the firms themselves (Syverson 2011, 360; Backus 2015, 39).

There are authors who state in their research that the control environment is the most important and fundamental component of the internal control system (Supriyanto and Deden and Mohd Haizam and Obsatar 2021, 6038). Therefore, when designing internal controls to create good corporate governance practices, a strong control environment must be created beforehand because without it, other control components, no matter how good they are, will not mean anything in achieving the objectives of internal controls, good corporate governance, and the organization's overall objectives. Some other authors (Liu and Nie and Huang 2018, 249) have also recognized the control environment as a very important element of internal control system that plays a vital role in implementing internal control and has a profound impact on the survival and development of the company.

The author Sackmann (Sackmann 2011, 216-218) identified almost 55 scientific papers that examine the relationship between organizational culture and performance and indicate their direct connection. One of them is a study by the author Flamholtz whose results showed a statistically significant correlation (at the 0.05 level) between culture and financial performance (measured by "EBIT" or earnings before interest and taxes) (Flamholtz 2001, 268). The research conducted by the authors Graham, Grennan, Harvey and Rajgopal among 1,348 companies in North America showed that more than half of the top executives believe that corporate culture is one of the three most important value drivers for the company, while 84% of them believe that improving corporate culture would increase the value of their company (Graham and Grennan and Harvey and Rajgopal 2022, 552). And many other researchers, such as Waal (Waal 2010, 5-6; 32-33), then Shahzad (Shahzad et al. 2012, 975), then Xiaoming and Junchen (Xiaoming and Junchen 2012, 31-32), and Owoyemi and Ekwoaba (Owoyemi and Ekwoaba 2014, 168) argue that a strong organizational culture contribute to better organizational performance and sustainable competitive advantage.

However, some authors point out that this contribution does not exist in every case, but rather depends on the type of organizational culture. In this sense, Ogbonna and Harris show in their work that bureaucratization reduces short-term profitability, hinders long-term growth, and can even affect the survival of the organization (Ogbonna and Harris 2000, 782). On the other hand, competitive and innovative cultures, which are sensitive to external conditions, have a strong and positive impact on organizational performance. Similar conclusions were reached by Garg and Ma who studied the impact of cultural differences on the organizational success of three different types of organizations (foreign-owned, joint ventures, and domestic (Chinese) ownership) (Garg and Ma 2005, 268-69). The results showed that the success of foreign-owned enterprises is significantly

better, which is attributed to elements of the control environment, such as teamwork, accountability, efficiency, and management style.
A number of researchers and authors have shown that there is a significant impact of enterprise risk management on organizational performance (Nocco and Stulz 2006; Gordon and Loeb and Tseng 2009; Hoyt and Liebenberg 2011; Thomya and Saenchaiyathon 2015), and organizational culture is one of the fundamental elements of this process. Therefore, it is clear that the quality of internal control systems, as well as risk management processes, largely depends on the quality of the control environment, and all together contribute to better business results and long-term sustainability. Namely, the control environment can help reduce risks in the organization and contribute to successful risk management by recognizing risks in an easier way, and by designing policies and procedures to effectively prevent, detect, and respond to risks. In this way, unwanted consequences that could jeopardize the organization are minimized. On the other hand, organizations with weak control environments often face more risks because they do not have guidelines clear enough for preventing and dealing with risks. This is very important to keep in mind today when changes are more intense and getting faster, and risks are more and more present.

## 2.2 Organizational changes and organizational culture

Although changes are often equated with risks, there is still a subtle difference between them. Generally speaking, any deviation from the plan, especially if it relates to the scope of work, schedule, and/or budget, is a 'change'. However, if we can predict them, then we can manage them, and then we talk about risks. If we cannot predict them, then they are unexpected changes, and all we can do is deal with them when they happen.
Some authors (Nastase and Giuclea and Bold 2012, 15) point out that organizational changes are a result of responses to external challenges of macro and micro environments, as well as internal challenges such as innovations, crises, and conflicts, in order to adapt the organization to the developmental demands of society as a whole. Managing changes requires creating a *culture of change*, which means that the organization deals with it on a daily basis, not just occasionally.
Given that not all changes are the same, in order to understand and manage them more easily, authors often group them into several categories. Thus, Gilley, McMillan and Gilley divide changes from an evolutionary perspective into transitional, transformational, and developmental changes (Gilley and McMillan and Gilley 2009, 39). *Transitional changes* represent small and gradual, even incremental changes in people, policies, procedures, technology, culture or structure. These changes are usually initiated and implemented by executives of individual business units, departments, sections or the entire organization when a specific problem needs to be solved. Resolving priority issues leads to quick achievement of short-term goals, which fosters motivation to expand efforts. *Transformational changes* are radical changes in basic assumptions, deeply rooted ways of thinking, culture, strategy or other significant organizational paradigms. Although a successful transformational change results in positive effects that imply greater competitiveness, i.e. the ability of the organization to differentiate itself from others in the market, many studies have shown that in 75-90% of cases, organizations fail to successfully implement transformational changes (Cope 2003, 10). The reason lies in their complexity and the need to carefully plan and implement them in order to minimize risk and maximize benefit. *Developmental change* stems from the philosophy of continuous growth and development, which is ensured through the so-called dynamic stability - a culture of continuous dynamic change that, according to some researches (Abrahamson 2000, 75), can still be managed. Developmental changes arise when organizations continuously scan their internal and external environment to create working conditions that stimulate and reward individual innovations, growth and development, which means when they nurture an appropriate internal environment and organizational culture. This is confirmed by the

authors Hansen and Kontoghiorghes who, in their research, concluded that a strategic priority of quality, excellence and continuous improvement is necessary for quick and successful adaptation to change (Hansen and Kontoghiorghes 2004, 34).

The idea of the connection between organizational culture and the success of change management is not new and has been explored by several authors. Edgar Schein developed the theory of "organizational culture" which describes how organizational culture can impact resistance to change. He emphasized that organizational culture can either be a barrier or a facilitator of change. According to his research (Schein 2004, 394-402), organizational culture can contribute to the effectiveness of change if it has embedded assumptions of: *proactive problem-solving and learning, commitment to learning how to learn, trust in people and human nature, belief that the environment can be managed, commitment to truth through a pragmatic approach and inquiry, focus on the future, commitment to open communication, commitment to diversity, commitment to systems thinking, commitment to analysis to understand and improve culture*.

Cameron and Quinn developed the "Competing Values Framework" (CVF model), which links organizational culture to the success of change management. According to the CVF model, organizational culture can be divided into four types (Cameron and Quinn 2006, 37-45): *hierarchy culture, market culture, clan culture,* and *adhocracy culture*. Each of these culture types has different values, goals, and ways of operating. Cameron and Quinn argue that organizations with different types of culture have different readiness and success in managing change. According to their research, organizations with a *hierarchy culture* have difficulty adapting to change because they prefer stability and security. *Market-oriented* organizations are more open to change because they focus on innovation and competitiveness. *Clan cultures* are focused on community and collaboration, and are more open to changes that improve teamwork. *Adhocracy cultures* are the most adaptable to change because they are oriented towards rapid adaptation to the environment. Cameron and Quinn argue that it is important for organizations to understand their culture in order to develop strategies for managing change.

In his book "Organization Theory and Design", Richard L. Daft explored how organizational structures, processes, and cultures can influence change management in organizations. The author believes that organizational structures and processes can be a barrier to change in an organization if they are too centralized or hierarchical. In addition, organizational culture can also be a barrier to change if it is not open to innovation or experimentation. To successfully manage change, Daft suggests that organizations need to create adaptable structures and processes that allow for faster adaptation to new situations (Daft 2007, 382-387). This includes *minimizing boundaries between different organizational parts, valuing equality and trust, and cultivating a culture that encourages risk-taking, change, and improvement*.

Mosadegh Rad conducted a study (Mosadegh Rad 2006, 606) to determine the influence of culture and its values on the success of TQM implementation in university hospitals in Isfahan, Iran. His research showed that hospitals with an organic organizational structure and a moderately strong organizational culture had greater success in implementing TQM than mechanistic and bureaucratic hospitals with weak organizational culture. Many authors (Bernardes et al. 2020, 1) investigated the relationship between flexible and hierarchical organizational culture, quality improvement areas, and authentic leadership skills in Canadian healthcare institutions. Their research showed that flexible organizational cultures influence the adoption of authentic leadership, participative management model, and improve quality.

Rashid, Sambasivan and Rahman conducted a study on 258 manufacturing companies in Malaysia (Rashid and Sambasivan and Rahman 2003, 161) to explore the impact of organizational culture on attitudes towards organizational change. Their results showed that organizational culture influences attitudes towards change and that different types of organizational culture have different degrees of acceptance towards organizational changes; while certain types of organizational culture can facilitate acceptance of change, others cannot. The contribution of this study is that its findings

confirm the results of previous studies that do not relate to the Western business environment, but also highlight the importance of culture in the processes of organizational change.
Uzkurt, Kumar, Kimzan and Eminoğlu conducted an interesting study in the banking sector (Uzkurt and Kumar and Kimzan and Eminoğlu 2013, 92) with the aim of examining the impact of innovation on the relationship between organizational culture and the business performance of banks, which is of particular importance for banks that want to achieve greater competitiveness by successfully introducing innovations in order to respond to changes in the environment. The authors conclude that mechanisms for stimulating and developing an innovative organizational culture are more likely to contribute to the introduction, adoption and spread of innovations, which will result in better bank performance. A similar study was conducted by Naranjo-Valencia, Jiménez-Jiménez and Sanz-Valle on a sample of Spanish industrial companies (Naranjo-Valencia and Jiménez-Jiménez and Sanz-Valle 2016, 1). They arrived at the same results, i.e. they showed that culture can promote innovation as well as company performance, but also be a hindrance to both, depending on the values promoted by the culture. They found that an adaptable culture is the best predictor of innovation and good business results.

### 2.3 How to respond to the challenges that changes bring?

As previously mentioned, many changes, particularly transformatinal ones, often fail. The main reason for this is the 'human factor' and numerous resistances that arise due to poor communication, misunderstanding of the goals to be achieved and/or insufficient resources (money, time, knowledge and abilities, willingness...).
When faced with changes, organizations essentially have two different approaches available: (1) the "causation" process, in which the desired effect is the starting point, and attention is focused on choosing ways to achieve that effect; and (2) the "effectuation" process, in which available resources are the starting point, and attention is then directed towards finding different effects that can be achieved with existing resources (Sarasvathy 2001, 245). The causation process is more typical of a traditional risk management approach, while the effectuation process is more suitable for managing unexpected changes that cannot be assessed in terms of the probability of occurrence and the effects they will have on the organization. Effectuation is essentially an approach in which changes are viewed as opportunities that can be leveraged using existing resources. The control environment is not only a set of policies, procedures, and practices that affect the way an organization is managed, but it is also a specific set of resources that can greatly assist organizations in their efforts to quickly adapt to changes in the internal and external environment and achieve their goals.
The authors agree that organizational culture can be a significant support, but also a major obstacle to implementing changes. There are common mistakes that organizations make when trying to introduce and implement changes, which relate to certain elements of the control environment. Leaders often expect resistance in advance, producing a negative Pygmalion effect, where people start behaving exactly as expected of them (Dent and Goldberg 1999; Ford and Ford and D'Amelio 2008). Employees' questions, dilemmas, and opposing opinions at different organizational levels are not taken into account, which prevents seeing a broader picture and the risks that necessarily accompany every change (Ullrich and Wieseke and Van Dick 2005; Ford and Ford, and D'Amelio 2008). Changes are managed only at the executive level; usually, a top-down approach is taken in which the top management creates a strategy, designs new structures and processes, and then expects everyone else at lower organizational levels to implement them unquestionably (O'Brien 2001). Fear is used as a management tool, raising panic by telling people they must change because the organization is in crisis (Stanleigh 2008). Thus, instead of proactive action, reactive action is stimulated, stifling creativity, ideas, initiatives, and active participation. Employees are often sent to different training sessions, and then it is expected that this is enough for implementing changes

(Stanleigh 2008). What is forgotten is the "tone at the top"; if leaders do not lead by example, behave ethically and with integrity, no training will encourage people to change (Burke and Litwin 1992; Fernandez and Rainey 2006; Gilley and McMillan and Gilley 2009). Employees are not given enough time to first understand what is happening and why, and then to embark on changes (Kotter 1995). The process of change is difficult, and on average, it takes 5 to 7 years for a change to be truly "implemented" in an organization. Without the appropriate environment, mindset, and readiness for change, it is unrealistic to expect any success, especially in the short term.
Given that rigid and bureaucratic cultures cannot respond to the challenges of today's dynamic environment and rapid changes, the control environment should also be a fluid medium that continuously evolves and adapts to the new demands of modern business. Essentially, changing the control environment towards encouraging open communication, collaboration, learning from mistakes, proactive risk management, and providing adequate training and resources can help improve an organization's risk management processes. By creating a culture that values risk management, organizations can better manage the risks associated with change and protect their employees, customers, and other stakeholders.

## CONCLUSION

Organizational culture, as an important aspect of the control environment, refers to the shared values, attitudes, beliefs, and practices that characterize the organization and guide the behaviour of its employees. A large number of authors and studies have shown that a strong control environment has a significant impact on the quality of internal control systems, as well as on the way the organization approaches risk management, including those related to changes.
Given that changes are today's only constant, whether they like it or not, organizations are exposed to changes every day. The way they react to them affects whether they will survive, fail or progress. The link between organizational culture and change management is reflected in the fact that the culture of the organization, i.e., its control environment, can either facilitate or hinder effective risk management during periods of change. For example, an environment that encourages transparency, communication, and collaboration is more likely to contribute to successful management of risks associated with changes than an environment characterized by strict hierarchical structure, resistance to change, and closed-mindedness. In an environment that values transparency and communication, employees are more likely to express concerns about potential risks associated with changes, and management is more likely to listen and take adequate measures to mitigate those risks. However, in an environment that is resistant to change, employees may hesitate to express their concerns and point out potential risks, and the management's leadership style may be slow to react to those risks, even if they are identified.
Therefore, a developed and adaptable control environment has the potential to help organizations more quickly and easily identify risks associated with changes and respond to them by taking advantage of opportunities and avoiding or minimizing threats and hazards. On the other hand, an underdeveloped control environment and rigid organizational culture can hinder these efforts and increase the likelihood of negative outcomes.

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