Culture risk
and the role of the internal audit.

How to audit organisational culture?

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Briefing summary

There is a huge diversity of definitions of organisational culture, although most break it down to the elements that compose it. A simple and widely recognised definition is the following: *the set of values, symbols and rituals shared by the members of a specific organisation, and that describe the way in which things are done* (Claver, Llopis and Gascó, 2000).

Another revealing definition of the concept of organisational culture is the one set forth by Geert Hofstede: *the collective programming of the mind that contributes a set of common values and distinguishes people of one organisation from another’s*. The following is a graphical way of describing organisational culture:

![Diagram of organisational culture]

The problem of internal auditing of organisational culture is the inability to easily measure qualitative aspects: what we are and what we think. Precisely, the elements described in the definition of organisational culture are usually intangible. For this reason, the way of auditing organisational culture must rest on the operational aspects of the elements that compose it, such as values, behaviour analysis and avoiding social influences while auditing.
Seizing the challenge

If one reviews the different definitions given for organisational culture, it is easy to see why it is sometimes arduous and difficult to audit it, although it does bring tremendous benefits when done correctly. Definitions provide keys to its execution.

Griffin and Moorhead say that it is the set of values that helps employees of an organisation to understand which actions are considered acceptable and which are not. Ouchi defines it as a set of symbols, ceremonies and myths that communicate to employees values and beliefs underlying the organisation. Spender thinks about it as a system of beliefs shared by members of an organisation, and Schein, as a pattern of basic suppositions that a certain group invents, discovers or develops while learning to administer their problems of external adaptation and internal integration, so one must arrive to the basic suppositions in each person. These suppositions are what determine beliefs about what is appropriate or not in their behaviours.

Although closely related, it is convenient to describe the definitive difference between organisational culture and organisational climate. Climate is based on individual perceptions and refers to the current situations within the organisation and recurring patterns of sensations, attitudes and behaviours of people. Organisational climate can be described as the atmosphere at a given moment.

On the other hand, culture, say Griffin and Moorhead, refers to the historical context in which a situation occurs, as well as the impact of that context on employee behaviour. It involves values and guidelines that affect the behaviour of employees, the weight of history and traditions, and therefore, it is considered hard to change organisational culture in the short term.
Graving the opportunity

If the key issue of the internal audit is to gather evidence and demonstrate that is the case and that the values are being lived at every level (Foster Back, 2014), and the decisive factor for the organisation is to link values and other elements of the organisational culture to daily practice, the internal auditor has the huge challenge of correctly evaluating and interpreting behaviours occurring within the organisation while avoiding social influence processes such as conformity and groupthink.

Evaluation of operation

Some of the dimensions of values are based on the axis around which the essentials revolve, and on the moral qualities that motivate an individual that faces a large enterprise. However, making these values operational is essential to be able to include them in the daily practice of everyone in the organisation and, in this way, achieve strategic objectives.

Values must be defined ultimately as the regulators of daily behaviour for people in an organisation, not just simple and pretty statements. Values are present in the organisation, but the decisive step is to link them to practice so that they create a new effectiveness. In making values operational or linked to reality, an essential part is played by the leader, who has the responsibility of communicating and serving as role model for the people that carry out the daily work towards attaining objectives.

Many organisations declare their own values and do it under concepts, such as "respect" or "excellence". But frequently, they do not represent anything beyond a declaration of intentions. They do not represent guidelines that are put into practice, just simple aspirational declarations.

An organisation's values are its essential principles. Companies that want to achieve success define a series of fundamental values that are immutable while business strategies evolve to adapt to changing needs. These values must be integrates into every process that involves people.
The internal auditor has the great challenge of evaluating whether these values are intrinsically and solidly rooted in the behaviour of people within the organisation. This evaluation must be done in both ways: from the values to the facts, attitudes or behaviours and from the fact, attitude or behaviour to the values.

Answering the following questions effectively will help the internal auditors in their evaluations:

In which concrete ways do values affect strategy?
How is strategy linked to values?

Which is the decision making protocol based on these values?
How does decision making affect each value?

In which specific behaviours do values have any meaning?
What meaning do values give to specific behaviours?

Which specific behaviours translate a values into a concrete thing?
How is a specific value deployed in specific behaviours?

Furthermore, in order to avoid potential conflicts between behaviours based on different values and to take certain risks, it is desirable to define a scale of values and operational protocols for such conflicts.
Making values operational: cases

The following cases make reference to organisations that have succeeded in making a value, or a few values, operational, achieving huge benefits for their growth, and that at the same time can be relatively easily audited.

Avon Products Inc.

AVON is an organisation that is dedicated to the production and distribution of cosmetics and perfumery products, maintaining the same values declared by its founder one hundred and thirty years ago: trust, respect, conviction, humility, and integrity. Its first value, trust, is clearly reflected by measures adopted by the Marketing and Sales department. Their sales system revolves around an open communication with the client, and the organisation recognises that it depends on the personal contributions of its workers. Avon fully and publicly trusts its own talent, who may take on risks and share their points of view with the client.

Zappos

Zappos defends its values on top of everything else. These are not defined as concepts, but as actions. Furthermore, this organisation that sells shoes is open to changes if these changes enable the business model to improve, and especially if these changes come from observing client responses. Other key issues include: that talent selection is based on the condition that talent shares the same values as the organisation, and that during the induction process, relationships are built with the talent’s new colleagues based on these values. From the crystallisation of these values, Zappos has grown exponentially since its foundation in 1999.
Kellogg’s

The K-values guide Kellogg’s business approach and the commitment of its stakeholders. Together with Global Code of Ethics they form a practical guide that attempts to get all stakeholders acting with integrity, co-responsibility, passion, humility and respect. They regulate people’s behaviour, as they are defined in terms of behaviour. Values are integrated into daily practice, and, in fact, are incorporated into the Performance Management Plan. Leader play a special role, as they are in charge of taking on and transmitting the company's values.

General Electric

For General Electric, innovation and growth had to be part of the organisation’s religion: growth had to be included in its DNA. Its values: passion, curiosity, versatility, responsibility, teamwork, commitment, openness, and energy "reflect the energy and the spirit of a company that has a solid base to lead change as business evolves". Based on these values, the three year strategy was updated to include a growth manual and the organisation was successful in creating a working climate based on innovation. The result was the expansion of teams to emerging markets and the launching of many initiatives to accelerate innovation.
Interpretation of the facts

A large component of an organisation's complexity is the number and meaning of observable behaviours. Behaviours, as psychological events, have always different interpretations: it is impossible to evaluate and judge them practically in a totally objective way.

However, the auditing activities must be approached with the best tools possible. A valuable perspective for undertaking this activity is the Emic and Etic perspective. These terms were proposed by the North American linguist Kenneth Lee Pike to describe two different types of comprehension for a single word: meaning and signifier. In anthropology, Marvin Harris adopted the terms Emic and Etic to use with cultural concepts of ever-increasing complexity.

This perspective may be used for organisations, where Emic indicates the meanings behaviour has for people, and Etic the description of these events which are observable and evaluable or measurable by an external observer. The points of view of an anthropologist when "auditing" a tribe would be a Emic viewpoint - the point of view of the native - and the Etic viewpoint - the point of view of an investigator carrying out field research. Knowing the meaning an observed behaviour has for a person is essential for the correct interpretation of this behaviour in the organisational context.
Avoiding social influence while auditing

People think, relate and mutually influence themselves. The power of social influence is so strong that people are never fully aware of its effects. Audits are not free of social influence. Further down, the social influence of a tragedy in an organisation that declares security as its main value will be observed.

At least, conformity and groupthink factors will gravitate dangerously over the autonomy of an audit on organisational culture. Understanding this phenomena it is possible to obtain some knowledge on why people feel certain sensations, judge in specific ways, and act in concrete cases.
Conformity

Conformity (Myers, 2005) is the change in a conduct or idea as a result of group pressure. Conformity can adopt two shapes: obedience and acceptance. The first case consists of showing exterior concordance with the present group, although there is an internal disagreement. On the other hand, acceptance is believing and acting in accordance to social pressure.

The following experiment, conducted by Solomon Asch, is a conformity classic. The researcher asked the participants to listen to judgements made by other participants about the comparative length of three lines relative to a model line, and then make the same judgement themselves. When the other participants - who were actors playing a part for the researcher - provided a wrong answer on purpose, the real participants conformed in a 37% of cases.

This experiment, using something as objective as the length of a line, together with other experiments in the same theme, indicate a tendency in people to show conformity when under group pressure, a pressure that many times is invisible. Social pressure has a greater force than what was previously thought, and may act in very subtle ways in activities with a great amount of information or of high complexity.
The Volkswagen case illustrates some of the phenomena involved in social influence. Power relations, in and out of the organisation, plus the conformity element, in its acceptance and obedience variants, seem to be behind some of the aspects of the Volkswagen scandal. In the same way, organisational culture can explain part of what has happened.

In regards to power relations, Dudenhöffer (eldiario.es) states that Volkswagen is a unique company due to the presence of the Lower Saxony Land as a shareholder, because there is a special Volkswagen law which grants the company rights no other businesses around the world have, and because of Mitbestimmung, or co-management, which gives workers an important role in decision making in a company that employs 600,000 people in about 100 factories worldwide. The Süddeutsche Zeitung newspaper points out a certain asymmetry in power distribution within the organisation, and an "autocratic leadership", as causing the lack of "effective governance".

Speaking about the characteristics of the organisational culture, Michel Freitag (Manager Magazin) says that Volkswagen is, in reality, a kind of exception in the industry, "where business culture is problematic". Ferdinand Dudenhöffer, an expert in the field and professor at the University of Duisburg-Essen talks along the same lines. Dudenhöffer says that the complex system that makes Volkswagen work is a "system where everything, industrial, public and union powers are highly mixed", and that this system was the one that allowed the company to manipulate the diesel engines and take centre stage in one of the largest scandals in the history of the auto industry.
Groupthink

Examples abound of costly, incorrect strategies adopted by teams made up of skilful and experienced people. When it is time to evaluate the failure, many people ask: how didn't we see it coming? Irving Janis analysed a series of important historical failures and found that these errors were produced as a result of the omission of divergences by the decision making group, in the interest of a general harmony. Janis called this phenomena groupthink.

There are eight symptoms that indicate that a decision making environment has been "infected" by groupthink:

- Unquestioned credibility in common morals: morals and ethics are ignored.
- Self-censorship: dissent is suppressed to avoid group rejection and uncomfortable disagreements.
- Mind guards: some people protect the group from information that might lead to evaluate other options.
- Illusion of invulnerability: the group is excessively optimistic or feels infallible.
- Illusion of unanimity: self-censorship and pressure not to spoil the consensus lead to the mirage of conformity.
- Stereotyped views of opponents: enemies are considered weak and not smart.
- Pressure for conformity: group members reject people who raise doubts about the plan.
- Rationalisation: a decision is justified to achieve consensus.
Groupthink case

In 1986, NASA decided to launch the Challenger shuttle into space. After its explosion, the failure was investigated and the base errors were identified as the inadequate decision making procedures and the phenomenon of groupthink. It is surprising then to see that the values declared by NASA as their own are safety, integrity, teamwork and excellence.

With the information collected during the investigation and relating it to groupthink, at least four symptoms (Myers, 2005) could be recognised:

1. Several engineers tried to convince NASA directors during months before the accident and until the night before about the dangers they had found, but were unsuccessful. *Illusion of invulnerability*.

2. On one occasion, a NASA official complained: "wow, when do you want to launch? in April?: *pressure for conformity*.

3. Only managers were consulted, ignoring engineers: *Illusion of unanimity*.

4. The NASA director that made the decision never new about the engineers' worries, protected from unpleasant information: *mind guards*.
In this disaster, organisational culture had a decisive role, the same as in the one that occurred seventeen years later. In Myers' words:

*In 2003, catastrophe hit again, after NASA removed five members from a group of experts that warned them about security problems in the ageing space shuttle fleet (Broad and Hulse, 2002). NASA said it wanted to bring fresh blood into the agency; however, some of the members of the group declared the real reason to be suppression of criticism, and that their worries were discarded, until they regained credibility when the Columbia shuttle disintegrated during its return to Earth, on February 10th that year. The Columbia Accident Investigation Board (2003) concluded that "physical and organisational causes played an equal part in the Columbia accident; that NASA's organisational culture has much to do with the disaster, as much as the material that hit the orbiter during ascent" and that order barriers "prevented effective communication of crucial security information and drowned differences in professional opinions.*
How to avoid groupthink?

Promote an open environment for discussion and develop a culture where disagreement is appreciated.

Try to be impartial, not take a position and implement a structured decision making process.

Request critical evaluations, encouraging replicas and questioning of alternatives, and don't assume silence equals agreement.

Designate a group member as a "devil's advocate" to provide feedback on proposed ideas.

Generate an anonymous feedback mechanism to encourage different ideas without identifying their authors.

Form small groups to debate separately and then reunite them to analyse common points and differences.

After reaching a decision, ask every member of the team to express their doubts.

Invite experts to meetings so that they may criticise the group's points of view.
In regards to the phenomenon of group thinking described above, it is important to highlight DIRECTIVE 2014/95/EU OF THE EUROPEAN PARLIAMENT AND COUNCIL, dated October 22nd, 2014, which modifies Directive 2013/34/EU about the dissemination of non-financial and diversity-related information by certain large companies and groups.

The commission pointed out the need to increase the transparency of social and environmental information provided by companies in all sectors to a high and uniform level for all member States, in relation to the dissemination of non-financial and diversity-related information (Official Journal of the European Union). This non-financial and diversity-related information is closely linked to the Groupthink phenomenon, where divergences are omitted by the decision making group in the interest of a general harmony.

Highlighted below are some sections of the text.

Diversity in competencies and points of view of members of administrative, management and supervision bodies in companies facilitates a good understanding of the organisation and business of the company.

This diversity enables the members of these bodies to put forward constructive criticism related to management decisions and be more receptive to innovative ideas, fighting in this way against the Groupthink phenomena, where points of view of group members are very similar.

Diversity contributes in this way to an effective supervision of management and a satisfactory company governance. It is important, then, to improve transparency over the applied diversity policy.

This would inform the market about corporate governance practices and apply indirect pressure for companies to increase diversity in their management bodies.
The Olympus case shows how a lack of cultural diversity causes the omission of differences, which is the definition of groupthink. This case also shows problems caused by false loyalty and organisational values which are not put into practise adequately. The scandal unveiled by Woodford, the first non-Japanese director of Olympus, came from the end of the 1980's. At the time, many Japanese organisations, drawn by low interest rates, bought properties, stocks, and other financial instruments. In 1990 the market crashed and some companies sustained heavy losses.

Olympus managers decided to hide them, instead of disclosing them. Successive managements kept the information and hoax hidden, and resold the debt to false funds at book value in order to maintain the balance sheet.

Japanese culture includes the defence of past and present management as a corporate value. Managers did not seek to profit, but to protect or maintain the honour of past and present administrations, a practice which is still common in many Japanese organisations.

Woodford did not share the values of the Japanese organisational culture, and was fired when he hired external consultants to carry out the audit, which was taken as an indication that he did not adapt to Japanese organisational culture.

Woodford extracted three valuable lessons:

- The "Tribalism" of a misunderstood loyalty, where media rarely investigates, stockholders ask few questions and "superiors" are almost never doubted.

- Corporate governance. Managers are notoriously reluctant to designate external members that may challenge their decisions. A system of crossed stock options impedes the control or firing of incompetent managers.

- Lack of "hostile purchases" and the "creative destruction" it brings about. As a result, mediocre executive can maintain strategies where they "do nothing" for years.
Culture and the role of Internal audit

With the objective of re-establishing trust in the public and private sectors, the challenges for an organisation, which are responsibility of their management, are: the definition of an organisational culture, an analysis of this culture, and the promotion of its values and ethics. The challenge of an internal auditor when faced with analysing organisational culture is approaching the complexity of the indicators that can be audited.

Many organisational culture models have been described in specialised literature, so the selection of a group of indicators to be audited must be approached carefully. However, this problem can be eluded if the internal auditors feel comfortable understanding organisational culture before they even start working with any indicators.

A cultural change is a very complex thing and much harder to provoke and manage than other changes, such as a change in the organisational environment, but it is clear that the internal auditor will have a fundamental role in this, as well as in risk culture.

*Risk culture is a term describing the values, beliefs, knowledge and understanding about risk shared by a group of people with a common purpose, in particular the employees of an organisation or of teams or groups within an organisation* (Chartered Institute of Internal Auditors). Organisations take risks in order to fulfil their mission and achieve their established objectives. However, their culture may significantly influence their capacity to manage risks and carry out activities which are not aligned with the organisation's policies and procedures. *The risk culture is not separate from culture in general* (The London School of Economics).
Internal audits require certain key facilitators to carry out their activity effectively and face the challenges of auditing organisational culture (Culture and the Role of Internal Audit - Chartered Institute of Internal Auditors).

These facilitators for auditing culture are: an analysis of the organisation's culture, which must be promoted from top management; a clear mandate for the internal auditors, which must be written down in the audit charter; a trust-based relationship with internal auditors which enables informal discussions about subjective judgements; position, treatment and regard for internal audit, and non-adversarial relationships with their clients; confidentiality of client reports and a good level of risk maturity in the organisation.

The challenges that arise from culture audits are: collecting evidence and demonstrating that the organisational values are embedded at all levels; the limitations of interviews, which frequently provide indirect or biased behaviour and skills indicators; learning (improvement of tools to identify weaknesses, combination of quantitative and qualitative methods and instinct in collecting audit evidence, improved communication and interpersonal skills in senior internal auditors, and evaluation of whether junior auditors can be successful in this field); type of result reports, which may be oral or written, each with their own peculiarities, and the issue of the credibility of the audit itself, as auditors are participants and at the same time evaluators of this culture.

Barclays is carrying out an approach towards auditing culture, integrating culture as a part of each audit and performing thematic reviews and evaluation of business areas (Culture and the Role of Internal Audit - Chartered Institute of Internal Auditors). Culture audits seek to understand whether values are disseminated among people in the organisation, and adopted by them, or demonstrating whether the obtained results are the ones expected.

About integrating culture as an element in every audit, this would be centred, as usual, around systems and processes, but will also be based on a good underpinning risk culture, and will analyse whether a behaviour or set of behaviours are causing a problem.

To carry out the evaluation, a set of information types will be selected: human resources data, reports on irregularities, complaints, cultural surveys and mystery clients, as well as structured interviews developed by psychologists.
The indicators they are looking at are broadly similar to the ones set out by the Financial Stability Board i.e. tone from the top; accountability; effective challenge; and incentives.

A different approach is being tried by TUI Travel plc., for which the organisational culture reflects an appetite for risk and the effectiveness of the management board (*Culture and the Role of Internal Audit* - Chartered Institute of Internal Auditors). It must provide a clear tone at the top, and then guarantee an efficient system of compliance control. Part of this control system is the internal audit, although, in order to be successful, a cultural change must be achieved so that an active role can be taken at the top. For this purpose, both talent and method must be developed.

The methodology for internal audit activities must be refined to allow internal auditors to have adequate relationship types with the organisation. It is also necessary to have an adequate workforce: that is, competent, compassionate, commercial, and sometimes brave people.

The improvements TUI Travel is including in its internal audit methodology are the following:

Commitment: the internal audit informs the management that they will provide an assessment of their commitment. Management can choose their way to interact with the team, in an open way or defensively.

Context and Credit: due to the fact that audit reports may cause resentment among people in management, internal audits have developed standard mechanisms to provide adequate context and credit.

Stakeholder feedback: a written response is allowed over the established conclusions, although sometimes they are edited for brevity and preciseness. Management is offered the possibility of providing non-restricted feedback. All comments and scores are reported quarterly to the audit committee. Response and feedback rates are a good indicator of the current organisational culture.
Performance reporting: reports presented by internal audits enable the production of an image of the commitment and effectiveness of individual managing directors, including:

- The timely closure of corrective actions (which shows performance over four quarters highlighting the best and worst).

- The appropriate authorisation of date extension requests (which show that all requests were presented to the CFO).

- The number of repeated requests (which shows the number of times the dates were changed, where more than two times indicates commitment and/or competency problems).

- Compare and contrast reports (which show the results of the same audit carried out in different companies).

- The Risk Management Engagement & Effectiveness Grid, which shows the performance of each General Director in relation with his/her peers.

- Hit Rate & Root Cause Analysis (showing, for common control weaknesses, how many times the control was tested, how often it failed, how badly it failed and why it failed).

Personnel surveys: questions have been added to the annual personnel survey by the internal audit, as they provide a good map of good and bad culture in a transversal manner.
Learnings and take-aways

Make values operational, evaluate both ways - from the value to the fact, attitude or behaviour and from the fact, attitude or behaviour to the value - and evaluate the rest of the cultural elements appear to be the essential actions when auditing an organisational culture. They allow declarations of intentions not to stay as mere aspirations.

In order to carry out an organisational culture audit with higher levels of effectiveness, it must include the interpretation of the meaning people give to their behaviours within the organisation, being conscious of social influence types that will inevitably occur, conformity and groupthink.