GLOBAL PERSPECTIVES AND INSIGHTS:

Auditing Culture – A Hard Look at the Soft Stuff

The Institute of **Internal Auditors** | *Global*

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Anyone who was in the business world some 15 years ago remembers the debacles associated with organizations such as Enron, WorldCom, and Adelphia. (While all United States-based examples, similar debacles have played out globally.) People watched astonished, dismayed, and disgusted as the stories unfolded, revealing a world of alleged corporate misdeeds and misconduct that rocked global financial markets and saddled innocent employees and stockholders with irreparable financial damage. Financial pundits wondered how the controls designed to make this sort of malfeasance impossible could have failed so completely. Cynics nodded their heads knowingly and suggested that perhaps this would awaken naïve consumers to the ugly realities of corporate life and underscore the negative aspects of capitalism run amok.

Surely, a decade and a half removed, we can breathe a sigh of relief and feel confident that this sort of corporate malfeasance is behind us. Sadly, given current events that are ever-present through every media channel, that is not the case.

There appears to be no shortage of corporate misbehavior and other manifestations of unsavory corporate culture, which begs the question of not only, "Where were the board and executive management?" but quite frankly, "Where is internal audit?" Perhaps more than ever, internal audit is faced with both a challenge and an opportunity. It is uniquely positioned to bring value to the organization by doing the hard work on the soft stuff — auditing culture.

What Is Culture?

A simple definition of culture is that it is "the way we do things around here." While that might provide a good baseline understanding, culture is more than that.

The Group of Thirty (G30), in a recent publication focused on banking culture,[1] speaks of culture in terms of values and conduct, noting that they are the building blocks of culture and provide a practical platform for examining, improving, and auditing culture because they are observable and measurable and lend themselves to being formalized in principles and standards. In addition, values and conduct can be tangibly demonstrated by senior management, setting the vital tone at the top.

"Auditing culture must be incorporated into every audit engagement, providing the organization with a baseline for continuous monitoring and enabling internal auditors to look for early warning signs."

– *Angela Witzany,*
  CIA, QIAL, CRMA,
  Senior Vice Chairman,
  The IIA International
  Board of Directors,
  Head of Internal Audit,
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[1] G30, "Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform," July 2015.

Global Perspectives:
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Bad News About Bad Deeds

Corporate misconduct continues, apparently unabated.

- In September 2015, Volkswagen admitted that it developed and installed software designed to circumvent U.S. emissions rules. The auto maker has announced it will repair up to 11 million vehicles equipped with the software, an undertaking that is expected to cost more than US$6.5 billion, and will focus on overhauling its namesake brand.

- As reported in EY's "Europe, Middle East, India and Africa Fraud Survey 2015," 51 percent of the respondents agreed that bribery and corruption is widespread in their country, and an even higher percentage (61 percent) indicated seeing corrupt practices happening widely in rapid-growth markets. Thirty-seven percent of respondents noted that companies in their country often report better-than-actual financial performance.

- In March 2015, Germany's Commerzbank AG agreed to civil and criminal settlements with U.S. federal and New York state authorities for violating U.S. sanctions laws. Commerzbank also reportedly violated the Bank Secrecy Act of 1970 and other anti-money laundering laws by failing to have a sufficient compliance program to detect suspicious activities and stop high-risk transactions in advance, which came to light in the probe related to the Olympus Corporation fraud situation.

- In the most recent National Business Ethics Survey of the U.S. Workforce[2], which focused on employees' observations of misconduct in the workplace, employees characterized roughly two-thirds of observed misconduct as a multiple incident/ongoing pattern of behavior, having occurred at least twice. One-time incidents accounted for only one-third of ethical slips. Employees also reported that managers are responsible for 60 percent of workplace misconduct, with the likelihood of rule-breaking increasing with each step up the corporate ladder.

It is also useful to consider what culture is not. It is not a set of prescribed standards, regulations, or practices that apply equally and perfectly to every organization. Culture is a unique component of every organization's personality. What works in one company may not work in another.

A strong culture tends to rely on two-way conversations more than pronouncements from the top, a collaborative approach to decision-making, and team-based effort to get the work done. Much can be learned about an organization's culture by examining its attitude toward governance, its relationships with customers, what is important to the organization (as reflected in its values), how it treats employees, how it reacts to negative events, and how it behaves toward its competitors and within its community.

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[2] Ethics Resource Center, "National Business Ethics Survey of the U.S. Workforce," 2014.

Why Culture Should Be Part of Every Engagement

Unethical behavior ultimately puts an organization at risk and can indeed be placed at the heart of many organization failures. Anything that is so critical to an organization's success should be examined thoroughly and consistently. *Forbes* magazine recently called culture the most overlooked element of audits, and noted, "A culture audit sheds light on a company's core DNA, that which guides decision-making, problem-solving, and cross-functional communication processes."[3]

Auditing culture supports the delivery of stakeholder value by enabling organizations to proactively manage risk and reactively correct internal control failings before things go horribly awry. To serve that critical "early warning" function, culture audits or assessments cannot (with few exceptions)[4] be relegated to once-a-year exercises. They must be incorporated into every audit engagement, providing the organization a continual baseline of monitoring by enabling internal auditors to look for and establish meaningful trends and commonalities. While culture is often thought of as a pervasive, enterprisewide "mindset," it is as much a localized phenomenon that can vary by region, branch, department, and/or locale.

Regular and ongoing assessment of culture can be especially useful in organizations that operate in multiple jurisdictions. Culture manifests itself locally and employees in distant locations, regions, or geographies may be hesitant to contact a headquarters operation to report real or perceived problems with culture or ethics. Open discussions of culture can help ensure broad understanding of expected behaviors and encourage reporting.

Assessment results can provide support to those in each jurisdiction who are responsible for addressing cultural issues. How a localized culture supports or diverges from the overall organizational culture is important to understand and, if problematic, address.

The Three Lines of Defense and Auditing Culture

Understanding the three lines of defense model (or other suitable model delineating risk and control duties/responsibilities and reporting lines)[5] is as effective in assessing culture as it is in supporting standard audit engagements.

1. The first line of defense — business line management — is responsible for setting, communicating, and modeling desired values and conduct.

2. The second line is an oversight function, such as an ethics office, that develops ethics programs, monitors culture-related risks and compliance with culture-related policies and procedures, and provides advice to the first line.

3. The third line — internal audit — evaluates adherence to the organization's stated and expected standards and evaluates whether the corporate culture supports the organization's purpose, strategy, and business model. Internal audit assesses the overall culture and identifies areas where the culture is weak.

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[3] Forbes, "Culture: The Most Overlooked Element of Audit," Sept. 29, 2014.

[4] One exception is providing assurance over the organization's compliance and ethics program, which does lend itself to a one-time, periodic audit. The United States Sentencing Commission Guidelines Manual, chapter 8, section B2.1, Effective Compliance and Ethics Program, calls for a periodic assessment of the organization's compliance and ethics program, notably the risk of criminal conduct. Similarly, ISO 19600:2014, Compliance management systems — Guidelines provides guidance for establishing, developing, implementing, maintaining, and evaluating an effective and responsive compliance management system.

[5] The IIA's Position Paper, "The Three Lines of Defense in Effective Risk Management and Control," 2013.

What to Audit and Measure

Many considerations can be taken into account when auditing culture, examples of which are listed below. The internal auditor should be sure that the culture aspect of the audit is tailored for the organization and focuses on its specific environment, opportunities, and challenges.

Satisfaction/Opinion Considerations

- Employee observation of misconduct and reporting of same.
- Employee perception of his/her peer environment and culture.
- Employee belief that a strong tone from the top exists.

- Employee perception of the compliance and ethics program, and the importance of compliance and ethics within the organization.
- Employee and customer survey results.
- Customer complaints.

Training

- The existence of a comprehensive training program for new and existing employees, customized for the employee's role in the organization.

- Frequency of training and documentation of attendance.
- Mechanism for assessing the effectiveness of training.

Compliance

- Protection of whistleblower status and rights (e.g., monitor for a downgrade in job title, performance evaluations, or job assignments of employees who have or are believed by others to have blown the whistle).
- How frequently the organization faced legal problems.

- Number of risk and control problems identified by internal audit and other assurance groups versus the number self-identified, voluntarily disclosed, and proactively addressed.
- Timeliness and effectiveness of corrective actions.

HR Practices, Incentives, and Enforcement

- How frequently the organization received negative media coverage (including social media).
- Appropriateness and consistency of penalties for violating policies.
- Appropriateness of how honest mistakes are dealt with.
- Employee turnover.

- Whether exit interviews are conducted (because of the opportunity they present to gather an employee's honest perception of the company and culture) and whether those exit interviews include questions to assess whether the departing employee was aware of potentially unethical events taking place at the company.

Evidence of Soft Controls

- Competence — being adaptable and willing to learn.
- Trust and openness — teamwork, helping and relying on one another to solve problems.
- Strong leadership — direction and leading by example.

- High expectations — striving to improve, to raise the bar.
- Shared values — doing the right thing in the right way.
- High ethical standards — honesty, equality, and fairness.

How to Audit Culture

As a regular part of assurance and advisory engagements, assessing culture calls on internal auditors to exercise the same good practices they exercise throughout any audit: adherence to appropriate standards and principles, use of insightful interview techniques, application of focused investigation procedures, and reliance on objective evaluation. Credibility and trust are paramount in encouraging employee open participation. And good communication — especially with the management of any troubled areas — is necessary to effect change in, at least hopefully, a non-confrontational and collaborative manner.

Internal audit cannot effectively assess culture without a profound and deep understanding of the organization's values and expected behaviors coupled with a thorough appreciation of how they influence the organization's priorities in relation to good governance, risk management, and control. Developing this understanding should be a group effort involving not only internal audit staff but also other applicable disciplines, especially compliance and ethics. The resulting clear understanding enables internal audit to focus on indicators of culture and undertake root cause analysis — isolating and understanding why issues occur and how they can drive unwanted underlying behaviors.

Internal audit's perspective and function make it especially suited to focus on corporate culture, but good preparation is necessary to make it successful. To prepare to incorporate culture into every engagement:

1. **Leverage available resources.** For example, the Financial Stability Board offers guidance on assessing risk culture in financial institutions[6] that could be adapted to assessing overall organizational culture in any industry or sector. The guidance identifies four major areas that may influence an organization's risk culture — tone from the top, accountability, effective communication and challenge, and incentives. The guidance also identifies multiple performance indicators for each area. It is important to take special note of the difficulties, limitations, and potential stumbling blocks these resources discuss; they are undoubtedly based on past experiences.

2. **Review employee engagement surveys or other similar tools used by organizations to measure job satisfaction and predict performance.** Engaged employees have good things to say about the organization, are committed to their work, and plan to stay with the organization. While performing internal audit activities, look for opportunities to conduct root cause analyses in areas where employee engagement levels are high or low. Explore correlations between employee engagement levels and audit findings, and partner with human resources to provide insights on strengthening culture.

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[6] Financial Stability Board, "Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: A Framework for Assessing Risk Culture," April 2014.

Micro and Macro Cultures

Culture is not a monolithic, homogeneous entity within an organization. Each company has microcultures and macrocultures.

The microculture is, as its name implies, a smaller, more contained way of behaving; it reflects how employees and groups interact within an organization. Most organizations have many microcultures. Each department may have its own microculture, and must navigate the sometimes choppy waters of making its microculture work effectively with other, very different microcultures within the organization.

The macroculture is more expansive and external; it characterizes the ways an organization behaves in the marketplace with customers, stakeholders, and competitors.

This distinction is especially important to internal auditors. As they audit culture, they must remember that the tone at the top is not set solely by the CEO. Each microculture has someone at the top who is setting the tone for that group, and it is not always a tone that aligns perfectly with that of the macroculture. Internal audit's comprehensive view of the organization makes it possible to examine each of the cultures and offer recommendations for improved interaction.

3. **Secure the support of the board, the audit committee, and executive management.** Good protocol calls for speaking to the chief executive officer (CEO) before taking the topic to the board and audit committee for discussion, so that the CEO is sufficiently apprised. Ideally, the CEO, board, and audit committee should all champion the continuous assessment of culture. Next, seek the support of executive management, because their willingness to support internal audit's assessment of culture in all audits is key to how effective the process can be. Resistance should not deter internal audit from proceeding with assessing culture, but the auditor must understand the environment in which he/she is working. And, the reason for, or basis of, any such resistance may be a subtle clue to brewing cultural troubles.

4. **Make two separate but possibly interdependent decisions.** One is determining the combination of tools or approaches that will best fit the organization. Observation is likely to be a primary approach, but attention should also be paid to measurable tools, like employee surveys, to gather metrics that are indicative about culture. Culture does not easily lend itself to the hard proof that auditors normally gather through traditional control testing; this scarcity of concrete evidence is something the board and executives must understand, expect, and be willing to accept. However, the more the internal auditor can use surveys and structured interview techniques, the more concrete the evidence will be.

The other decision focuses on how to approach the culture aspect of the audit. One way is to use a maturity model. This involves asking the senior management and the board to identify the attributes of the organization's culture, estimate how mature the organization is for each, and propose how mature they want to be. Internal audit work can then determine where the organization actually is in relation to expectations. Identifying where gaps exist can help suggest where best to emphasize culture assessments in certain audits.

5. **Train the staff.** As already noted, internal auditors assess culture using the same competencies they regularly apply to their audit engagements. Business acumen, one of 10 core competencies necessary for successful internal auditors,[7] includes taking account of cultural aspects of the organization. While some auditors may at first find the more subjective nature of organizational culture a bit out of their comfort zone, this can be mitigated through training and experience, which underscores the importance of continuous career development and skills enhancement.

6. **Supervise auditors closely to ensure that subjective material does not lead them to jump to false conclusions.** Jumping to, and reporting on, insufficiently reached conclusions can cause all manner of ill feeling within the organization. As is customary audit practice, internal auditors must work with management at all levels during all stages of the audit to verify assumptions so that any false conclusions are handled before any reports are issued.

"Culture is the single biggest determinant of behavior in any organization. ... One thing that is clear — if you're not managing culture, culture is managing you."[8]

– *Keith Darcy, Independent Senior Advisor, Deloitte & Touche, LLP, Former Executive Director, Ethics and Compliance Officer Association*

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[7] The IIA, "The IIA Global Internal Audit Competency Framework," 2013.

[8] Keith Darcy, "Ways to Build Strong Ethical Cultures," Risk & Compliance Journal, Deloitte Insights, April 6, 2015.

Other Considerations

It is important to remember that the results of auditing culture in one area of an organization may not reflect the overall culture of the entire organization. Ultimately, results from multiple areas will need to be aggregated into an entitywide view. In essence, auditing culture is a top-down and bottom-up exercise that requires continuous evaluation, reconciliation, and calibration.

Some organizations use The Committee of Sponsoring Organizations of the Treadway Commission's (COSO's) *Internal Control – Integrated Framework* to enable the aggregation. Under the COSO framework, culture is addressed in Principle 1 of the Control Environment Component: The organization demonstrates a commitment to integrity and ethical values. Points of focus under this principle address tone at the top, standards of conduct, adherence to standards of conduct, and deviations from standards of conduct throughout the organization.9 If issues with this principle keep bubbling up to the surface, chances are a cultural issue is at the foundation; this can be diagnosed through root cause analysis.

Other organizations rely on surveys to aggregate findings. They create their own survey consisting of ethics- and culture-related statements (e.g., "The company behaves consistently with its core values," and "I have received ethical training for my job.")[10] and ask the employees of the area being audited to respond on a scale from "strongly agree" to "strongly disagree." For those statements receiving a high percentage in the "disagree" or "strongly disagree" categories, the internal auditors seek corroborating evidence. If they do not find any, they advise the appropriate management about the poor survey results. Employee perceptions can be wrong or may reflect either a lack of understanding or even a complete misunderstanding of the processes in place; sometimes direct management intervention, such as through a well-crafted communication can help address the situation. If corroborating evidence is found, the survey results, evidence, and recommendations for improvement should be reported.

Many organizations already have an entitywide employee survey, typically managed through human resources, which can be used as a springboard for assessing culture. Internal auditors can review the survey to determine whether there are any questions related to culture and ethics, and if not, they can ask to add a few. Any culture-related questions that score negatively can be used in several ways: to help identify potential risks to evaluate in the future, to plan and scope the audit plan for a particular area, to compare against testing done and exceptions found during the audit, and to investigate immediately (if warranted).

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9 The Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Internal Control-Integrated Framework*, May 2013.

10 Some internal auditors also give the management of the audited area the opportunity to add a statement or two specific to the area or current issues.

Regardless of the type of survey used, two factors must be in place for it to be effective:

- Employees must feel safe to provide honest answers. They more likely than not will avoid offering needed information if they fear losing their job or any other lesser form of retaliation.

- Employees must feel that concerns reported will be duly considered and appropriately acted upon.

At the conclusion of an audit, internal audit professionals report the results in a clear, objective way to the board and/or other appropriate bodies. Incorporating culture into the audit does not change this; culture is just one more factor that is covered in the report. However, addressing culture may necessitate a different type of dialog with the audit committee chair and CEO, using more subjective judgments and requiring enhanced communication skills. And, periodically aggregating a series of culture assessments over time into a more holistic view can be insightful and impactful for such an audience.

Just as with every topic on which internal auditors report, potential issues should be communicated regularly to management while the audit is underway. Audit observations and conclusion should not be a surprise to management when the report is delivered. It is important to remember that, since culture begins with the tone set at the top, internal audit may have the best purview to see the entire organization and be able to report objectively on how the culture is being either supported or subverted.

Closing Thoughts

Internal audit's annual work plan already includes many facets of the organization. Why should culture be added to the workload? Because auditing culture helps the organization manage it. Imagine an organization trying to manage its finances or internal processes or information systems without the necessary ongoing audits to glean where there are gaps, failures, miscommunications, or, worse, malfeasance. Given the overwhelming importance of culture to organizational success, a company's failure to audit it on a consistent, continuous basis sends a clear — and likely unwelcome — message to stakeholders about its values and priorities.

For More Information

Ethics and Compliance Initiative (*www.ethics.org*)

Society of Corporate Compliance and Ethics (*www.corporatecompliance.org*)

Compliance Week (*www.complianceweek.com*)

Ethisphere (*www.ethisphere.com*)

Financial Stability Board (*www.financialstabilityboard.org*)

Chartered Institute of Internal Auditors (*www.iia.org.uk*)[11]

The Compliance and Ethics Blog (*www.complianceandethics.org*)

Association of Corporate Counsel (*www.acc.com*)

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[11] See "Culture and the Role of Internal Audit: Looking Below the Surface" for real-world examples of how organizations audit culture.