CORPORATE CULTURE AND THE ROLE OF INTERNAL AUDIT

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Abstract: Corporate culture is high on audit committees' agendas. It is important to understand what to look for and how to measure something as nebulous and intangible as culture. Latest research shows that organizations are taking an interest in culture like never before; not because they are being forced to, but because they know a healthy culture is integral to their bottom lines, even their survival. Corporate culture is an intangible asset, yet intangibles can be transformed into visible value for the organization in the form of corporate agility, innovation, know-how, staff morale, brand reputation and image. Public and regulatory scrutiny of corporate culture has become even more intense. Internal audit is at the beginning of a long way to find an optimal approach to auditing culture.

Keywords: corporate culture, internal audit, corporate agility, innovation, staff morale, brand reputation

1 Introduction

An effective culture is one that ensures for organization achieving of the results which wants to achieve, both externally and internally – and in all areas. It's not just about profit and return on investment. It is about achieving the right results in terms of human performance, people being engaged with their work, doing the work they want to do as well as delivering on innovation as well as robust risk management and accounting practices. This paper aims to gather insight into corporate culture and the role of boards; to understand how boards can shape, embed and assess culture; and to identify and promote good practice. It has led the embedding and assurance work stream, looking at measuring and monitoring culture, the role of internal audit and risk management.

1.1 Responsibility of Governing Bodies

Corporate governance failure, especially within financial institutions, has been at the core of many of the problems during the global financial crises and numerous corporate and organizational scandals and failures. Many subjects have responded by issuing louder calls for increased regulation and by rethinking of guiding tools of internal audit processes like assurance.[1]

Boards and senior management have the prime responsibility for defining and analyzing organizational culture by promoting the values and the behaviors they wish to see across their organizations. Boards need assurance that a culture of learning from mistakes, rewarding the right behavior and systems and processes that produce the desired behaviors are being embedded across their organizations. A statement of values is not sufficient on its own; boards need to know that "espoused" values are the same as actual values on the ground. Providing assurance to boards around values on the ground is just part of the picture as culture is not merely the articulation of an organization's values. The use of gut feel can play a part in the audit of culture but in the digital age, assurance providers can make much greater use of hard as well as soft indicators to reduce the subjectivity of their findings. Data from internal reporting systems can be aggregated and used to identify trends and reveal issues of which the board may be unaware. The emergence of "big data" provides scope for internal auditors to develop specific skills and work with data analysts to provide insight. Who owns culture in an organization is an issue that boards and senior management need to resolve. It is unclear; otherwise, whom board committees charged with cultural issues should turn to for advice and guidance.

1.2 The Role of Internal Audit

Internal audit's role as the "inside-outsider" – being inside the organization but ostensibly independent and objective – is the key to succeeding in the culture assurance sphere. Internal auditors' knowledge and expertise in the organization's internal controls and its compliance programs mean that over time, they can build a well-informed perspective on practices right across the organization. No other function has a mandate to move across the organization in the same way that internal audit does. Internal auditors know which departments experience recurring problems and ones that don't act on, or are sluggish to respond to, audit recommendations. This means that internal auditors are well placed to assess the organization's culture, based on the practices and behaviors they observe.

Internal audit is one of the assurance providers that boards and senior management have turned to with some success, but there is still a long way to go. The positioning and reach of internal audit and the ability to "tell it how it is" are as important as the ability to audit cultural issues. Its role as the inside-outsider is the key to success when providing culture assurance. But audit committee members and senior executives must be open to the idea that, at present, there may be less hard evidence compared to more traditional audits and accept the likelihood of grey areas with differences of opinion. This may entail a change in culture and behavior at the audit committee itself.

Internal audit has a key part to play in assuring boards around culture. But this should not be confused with the idea that internal audit should be the board's sole assurance provider. This is because internal auditors need to have much more than the traditional skillset to succeed in this area. Furthermore, others have a role to play in embedding and assurance. It is critical for internal audit to have strong relationships with other functions across the organization.

1.2.1 Clear Internal Audit´s Mandate

It is crucial for the audit committee and any other board committees which are tasked with responsibility for organizational culture to give internal audit a clear mandate, and to write that mandate formally into the audit charter for the organization. In order to audit culture and behaviors, internal audit must become more insightful by developing a deep understanding of the organization and the environment in which it operates. The Institute's Financial Services Code[2] recommends that internal audit should have the right to attend and observe all or part of Executive Committee meetings.

We should not underestimate the fact that any employee has insight into the culture of their organization. It is not difficult to have inkling if there are problems with the corporate culture. Internal auditors can get a sense of culture by being alert to everyday behaviors and keeping attuned to the way the place feels as they walk around the corridors. It is a more organic and informal, but no less valuable, way to keep an eye out for cultural issues. A robust view from the auditor will rely on analyzing a range of data as well as these "corridor" observations. The success of internal audit's role in culture will hinge on convincing others in the organization of the value of its involvement. This perhaps speaks to the culture of internal audit itself. Ultimately, this value will rely on the quality and honesty of conversations internal audit is able to have with management. Internal audit, despite ostensibly being independent, is part of the culture/sub-cultures itself. It needs to be aware of and try to overcome its own biases. The function also needs to demonstrate sufficient accountability, and to have effective mechanisms for

[1] MUCHOVA M., *Basel Committee 2015 Corporate Governance Principles for banks*, Proceedings of Scientific Conference for Doctoral Students and Post-Doctoral Scholarship EDAMBA 2015, pp. 645-653, 2015

[2] *Effective Internal Audit in the Financial Services Sector,* Chartered Institute of Internal Auditors, 2013

communicating their concerns about culture to board members. Therein lie the real challenges.

2. The Culture and the Need for Assurance

When organizations fail, any subsequent review or post-mortem tends to attribute the failure to culture. Almost every corporate scandal of the last century will, in part, be due to certain cultural weaknesses – either by having the wrong tone at the top, or by individuals not acting in accordance with the organization's ethics and values. A harmful corporate culture can be detrimental to the long-term health of the company and its employees. Failures are very visible to customers, shareholders and the wider community and can seriously erode confidence and trust. Culture can be the difference between a business that lasts and one that crumples under pressure.

2.1 Values

A number of organizations use values as a short hand for the overall culture they are looking for. The values do not tell the whole story about culture; and people must be careful to distinguish between "espoused" values and actual values on the ground. Some corporate values statements and their development have been specifically engineered by boards. Other organizations have developed values, which are not necessarily stated, organically over time. Simply adopting formal values statements makes no difference in itself. Values need to be translated, to be communicated, and to have an impact on behaviors, in order to be able to influence the way business is done.

2.2 The Need to provide Assurance around Culture

Boards and senior management need to understand whether the culture they want for their organization is actually the one that exists in practice. Many believe that 'what gets measured gets managed'. In a large number of organizations, the human resources function is charged with measuring the organizational culture (through different tools), while employees are responsible for the actions and behaviors that create the culture.

Assurance providers primarily need to assure boards that the culture they have set is reflected in practice throughout the organization. Assurance providers can also advise on the robustness of the control framework. Internal auditors can, indirectly, help to embed the culture through the way they conduct audit activity; the advice and insight they provide to boards; and through the ways they flag up where the culture is not as expected. This way, the assurance provider can play a role in supporting (or 'carrying') positive cultural traits, or calling out traits that are not helpful. On the flipside, the internal audit function needs to ensure that its own culture does not negatively influence behaviors in the wider organization.

There are a number of assurance providers who can provide such assurance to boards on culture. Much of this work tends to fall to internal audit (both in-house and outsourced) or external consultants. It is worth noting that who assesses culture in an organization is an issue that needs resolving by boards and senior management teams. Lack of clarity on assessment can make it difficult for the audit committee, or other board committee charged with cultural issues, to decide who to turn to for support and advice.

3. Values and Culture on Behaviors and Decisions

Values and culture may be the keystone of financial institutions´ governance because they drive behaviors of people throughout the organization and the ultimate effectiveness of its governance arrangements.[3] The requirement aligns closely with auditing culture in that in order to develop an audit methodology that is insightful; auditors need to understand the prevailing culture within the organization.

Structures and processes are important, but how they are made to function is the key. Suitable structures and processes are a necessary but not a sufficient condition for good governance, which critically depends also on patterns of behavior. Behavioral patterns depend in turn on the extent to which values such as integrity, independence of thought, and respect for the views of others are embedded in the institutional culture.

Financial institutions' leaders stress the paramount importance of values and culture in driving behavior. Establishing proper institutional arrangements is relatively easy, but embedding the right culture tends to be much harder. In the best-run of financial institutions, positive values and culture are palpable from the board to the executive suite to the front line. Values and culture drive people to do the right thing even when no one is looking. They are a fundamental aspect of the governance system. Although values and culture cannot always be measured quantitatively, they impact governance effectiveness in powerful ways and therefore should be a major focus for the supervisor. What follows are specific views and recommendations designed to encourage financial institutions board members, executive leaders, supervisors, and shareholders to pay heed to the importance of values and culture and the hard work involved in getting them right:

1. Honesty, integrity, proper motivations, independence of thought, respect for the ideas of others, openness and transparency, the courage to speak out and act, and trust are the bedrock values of effective governance.
2. It is for the board of directors to articulate and senior executives to promote a culture that embeds these values from the top to the bottom of the entity. Culture is values brought to life.
3. Well-functioning boards set, promulgate, and embed these values, commonly in the form of a code, so that directors, senior executives, and all other employees in an entity are fully aware of the standards of behavior that are expected of them.
4. Because of their power to influence behavior and the execution of the financial institutions´ strategy, values and culture are essential dimensions of inquiry and engagement for supervisors. Major shareholders or their fund managers should be attentive to the culture of an entity when making their investment decisions and engaging with an investee board.

4. Culture and 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 organization or of teams or groups within an organization. Organizations in all sectors need to take risks to achieve their objectives. The prevailing risk culture within an organization will significantly affect its ability to manage these risks. An effective risk culture is underpinned by enabling and rewarding individuals and groups for taking well informed risks.

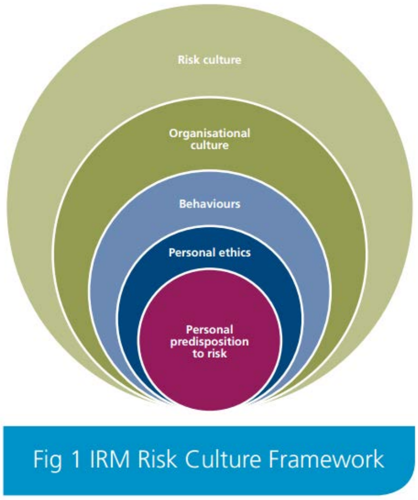
An inappropriate risk culture will lead to activities that are totally misaligned with stated policies and procedures or operate completely outside these policies. At best this will hamper the achievement of strategic, tactical and operational goals. At worst it will lead to serious reputational and financial damage. It is difficult to separate out organizational culture and risk culture and just focus on one or the other. Organizational culture both determines and is influenced by risk culture.

There has been much debate in the assurance world about the distinction between the two and perhaps, although not the final word on the matter, the risk culture framework developed by the Institute of Risk Management presents a neat depiction of the relationship. The framework attempts to distil the complex and interrelated set of relationships that influence risk culture. Risk

[3] *Toward Effective Governance of Financial institutions, The Group of Thirty*, ISBN 1-56708-156-8

culture is the sum of multiple interactions between these levels. At the lowest level, each individual's personal predisposition to risk contributes to their ethical stance, how they behave and make decisions. Group behaviors and the underlying organizational culture also influence risk culture.

Fig. 1: IRM's Risk Culture Framework[4]



Source:*https://www.theirm.org/knowledge-and-resources/thought-leadership/risk-culture.aspx*

5. Culture and the control environment

5.1 Models of culture – hard and soft controls

There are many models that look at the components of organizational culture. None can definitively capture the culture of an organization, nor be a predictor of specific behaviors. Most models make a distinction between what many people describe as hard and soft controls.

Hard controls are familiar as they refer to formal rules and activities that are common place, are tangible and reinforce the desired culture.

The COSO framework for Internal Control refers to the "Control Environment" which incorporates both hard and soft controls. Senior leaders should sponsor activities and initiatives that define, drive and monitor culture. They should seek to improve the control environment this area. Hard controls are the bread and butter of internal audit's remit; procedure, policy, and processes.

Soft controls are harder to define, but concern accompanying culture, behaviors, unwritten rules and attitudes. It is considering both types controls together that auditors can start to get a good picture of the culture.

Hard culture controls include:

a) The objectives that are set and how they are communicated throughout the business;
b) The success or failure of employees to complete relevant training;
c) Data management and analytics;
d) Timeliness of reporting of information.

Soft controls are more difficult to describe as they are less tangible than hard controls'. They can be best explained by giving some examples of 'soft controls':

1. Competence – being adaptable and a willingness to learn;
2. Trust and openness – teamwork, helping and relying on one another to solve problems;
3. Strong leadership – direction and leading by example;
4. High expectations – striving to improve, to raise the bar;
5. Shared values – doing the right thing in the right way;
6. High ethical standards – honesty, equality and fairness.

Effective work in relation to culture should help to correct internal control failings before they go awry.[5]

5. Conclusion

The governing bodies are the starting point for setting the financial institution's core values and expectations for the risk culture of the institution and their behavior must reflect the values being espoused. A key value that should be espoused is the expectation that staff act with and promptly escalate observed non-compliance within or outside the organization.
The governing bodies of the financial institution promote, monitor and assess the risk culture of the financial institution, consider the impact of culture on safety and soundness and make changes where necessary.

Organizational culture is an important area for internal audit to incorporate into its work. Internal audit can play both a key advisory role, and assurance role as part and parcel of their role in evaluating the risk and control environment with access right across the organization. If the appropriate checks and balances are put in place, and there are cultural issues bubbling up in financial organization, then there are ways to identify and address these before they become a major front page story or the subject of a negative media campaign.

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