

Culture clash

Policies, procedures and controls amount to little without the right culture says Hanif Barma

» CULTURE eats strategy for breakfast, or so say the management gurus. Having the right strategy, they say, is never enough for a business. If strategy is not aligned with the organisational culture, culture comes out top every time. Or, taking the internal auditor's perspective, all the policies, procedures, controls and systems that might exist count for nothing if an organisation does not have the right culture behind it.

The importance of organisational culture in supporting effective risk management is not a new concept, but the recent financial crisis has brought home how closely linked these are. At the end of last year, Independent Audit published a study, *Getting it right*, into risk governance outside of the financial services sector. The exercise involved extensive research through interviews and questionnaires. The most strikingly

consistent theme to emerge from our interviews – some eighty executives, non-executives, and heads of internal audit and risk from FTSE 350 non-financial services businesses participated – was that, since risk management is inseparable from good management, it is all about people and culture.

We were initially surprised by the number of hard-nosed businessmen and women who very quickly took the discussion of risk to topics such as culture, values and leadership. But the surprise wore off quickly and, by the end of our work, the few who did not emphasise these matters stood out as exceptions.

The view from the financial

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“Boards need to make sure their organisations have the right culture”

services sector today is not very different. In a speech earlier this year, Hector Sants, chief executive of the Financial Services Authority (FSA), outlined what the regulator is now doing differently in response to the financial crisis. He also highlighted a number of areas that, in his view, remained unresolved and had not been adequately addressed or debated: amongst these, culture and behaviour. If lessons from the past are to be learnt, he said, the culture and attitudes of financial firms will need to change.

Time will tell whether the FSA becomes more intrusive in its supervision should it perceive that a regulated firm does not have the right culture. But it is clear that behind the financial crisis was poor risk governance, and behind poor risk governance was inappropriate culture and behaviour.

Boardroom view

Boards need to make sure their organisations have the right culture. But what are they doing about it and do they spend enough time on this? Independent Audit has recently »

Cover story

» undertaken research in this area and our survey, *It's all about behaviour: how boards look at culture and ethics*, provides some interesting insights. Boards are certainly starting to look more seriously at the question of corporate culture and making sure their organisations have the right ethics. A quarter of boards surveyed say that, in the last year, they have fully discussed the values, ethics and behaviours they expect to be maintained throughout their organisation, a figure that goes up to 40% when the discussions in committee are included. (See figure 1).

Given the importance of the subject, it is interesting then to see that, whilst the same proportion (40%) of boards and committees discussed their organisation's programme for communicating the ethics policy internally to employees, only 12% of boards surveyed had considered internal communications at main board, so involving all board members. (See figure 2). And when looking at the external communication of its ethical standards and policies, only 4% of the boards surveyed had discussed this comprehensively. (See figure 3).

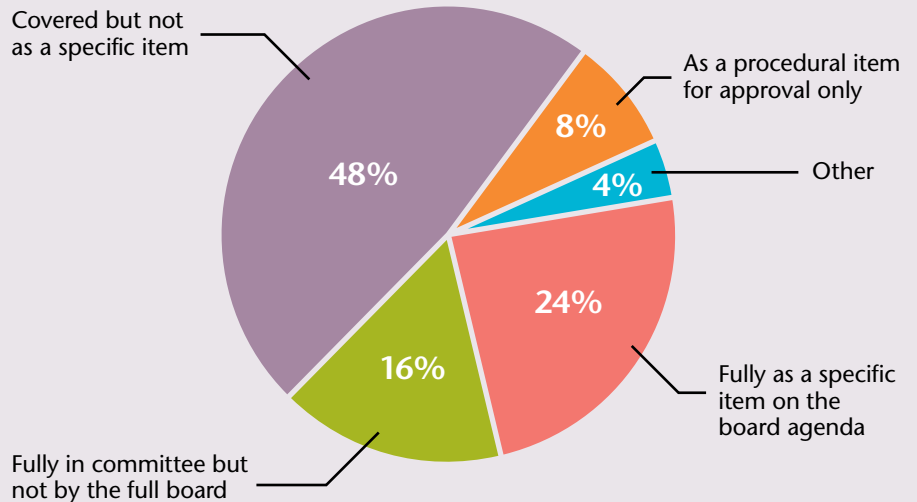
So, the question is, are boards taking the issue of ethics and culture seriously enough? The same question could have recently been asked of risk governance. A few years ago, I would not have been surprised to hear a board member say: "risk management, well that's embedded and management make sure of that". Boards that now do not take their oversight of risk seriously do this at their peril. Most boards nowadays spend a noticeable part of their agenda overseeing risk, and any non-executive director worth his or her salt will be ensuring risk management is happening effectively. So, I suspect, we're in a state of transition and I expect boards will be taking a much more active interest in culture and ethics in the next few years.

Two specific topics in the ethics and culture space seem to have preoccupied

Figure 1

The organisation's values, ethics and behaviour

In the last year, to what extent has the board discussed the values, ethics and behaviour which it expects to be maintained throughout the organisation?



Source: Independent Audit Limited

“Behind the financial crisis was poor risk governance, and behind poor risk governance was inappropriate culture and behaviour”

boards and their committees recently. Almost three quarters of boards surveyed say they have formally discussed reports on serious cases that had been identified, such as instances of fraud or issues raised through their whistleblowing lines. And almost 60% of boards have discussed the implications of the Bribery Act. What are the other boards doing, I wonder?

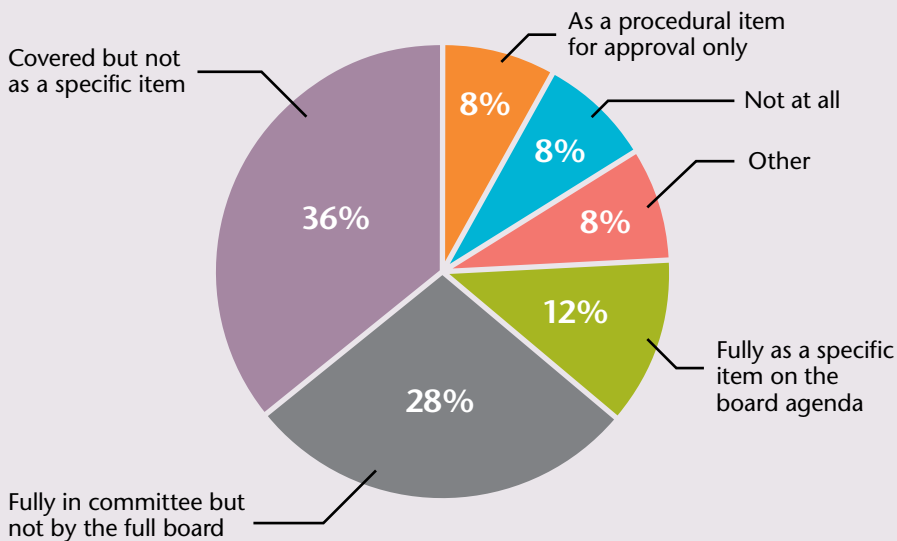
Lacking focus

But some specific areas are lacking focus on many board agendas. Our survey found that fewer than 50% of company boards have formally considered their organisation's exposure to reputational damage arising from ethical lapses. In addition, just over 40% of boards have formally discussed the potential impact of reward systems.

Fewer than 25% of boards have considered the effectiveness of their ethics programme in any detail;

Figure 2 Internal communications

In the last year, to what extent has the board discussed the programme for communicating the ethics policy to employees?



Source: Independent Audit Limited

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and fewer than 20% of boards have discussed feedback from staff on what ethical behaviour issues they feel they need management or the board to concentrate on.

Perhaps most disappointingly, no boards included in our survey had discussed the approach to, and results of, any assurance programmes in the areas of culture and ethics – though a quarter of boards did leave this to one of their committees, normally the audit committee.

But we know that boards think ethics and culture is important – that’s what they’ve told us – and they do get some assurance over this, even though it’s seldom discussed formally (even then only at committee rather than at full board).

Where do they get this assurance from? They tell us they rely primarily on conventional sources: compliance reports, external audit comments and – most importantly – from internal

audit findings. Yet, we found the majority of audit teams do not do much work specifically in relation to ethics and culture. (See figure 4).

What it all means

All very interesting, but what does this mean for internal audit? Five crucially important questions arise:

1. What’s your board doing?

Boards are taking more interest in culture and the impact it can have on performance and effective risk governance, but practice varies. Do you know how far up the culture curve your board is? You should at least be clear how forward-thinking your board is in this respect, and whether they see the importance of the link between the organisation’s culture and effective risk governance. Are there signs that the board are taking culture and ethics more seriously, and are they doing anything different? Are they spending more time understanding the gap

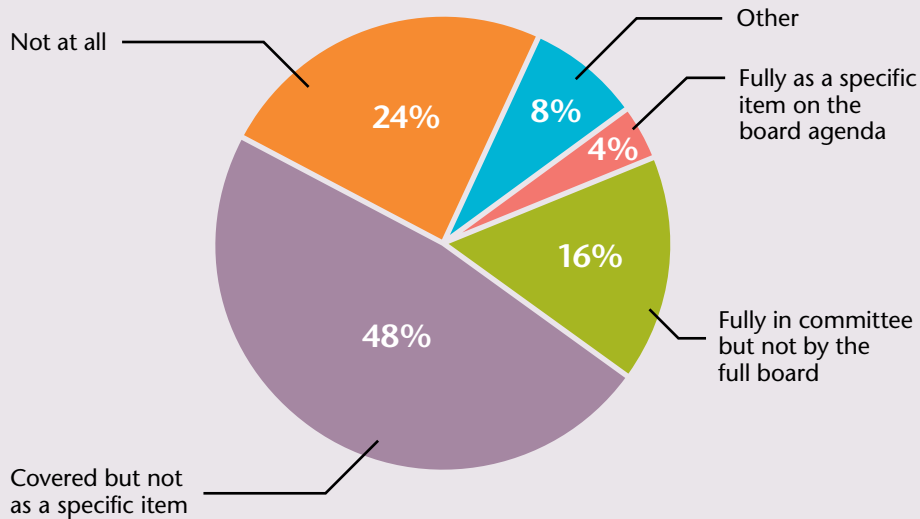
between the organisation’s current and desired culture? Are they proactive, or reactive – and is there a belief that “it could not happen here”? You need to understand your board’s perspective.

2. Are expectations clear? If boards say they rely on the work of internal audit for assurance in the area of culture and ethics but internal audit’s work is limited, are they drawing false assurance? It’s important to have a dialogue with your chief executive and finance director, as well as your audit committee, to understand what they expect and why they think they are getting the assurance they say they are. Do they really know what work internal audit is doing, and where else they are getting their assurance from? If they’re expecting more than is being delivered, maybe it’s time to do more.

3. What does culture have to do with the audit? In short, everything. Everyone nowadays says their audit »

Figure 3
External communications

In the last year, to what extent has the board discussed the external communication by the organisation of its ethical standards and policies?



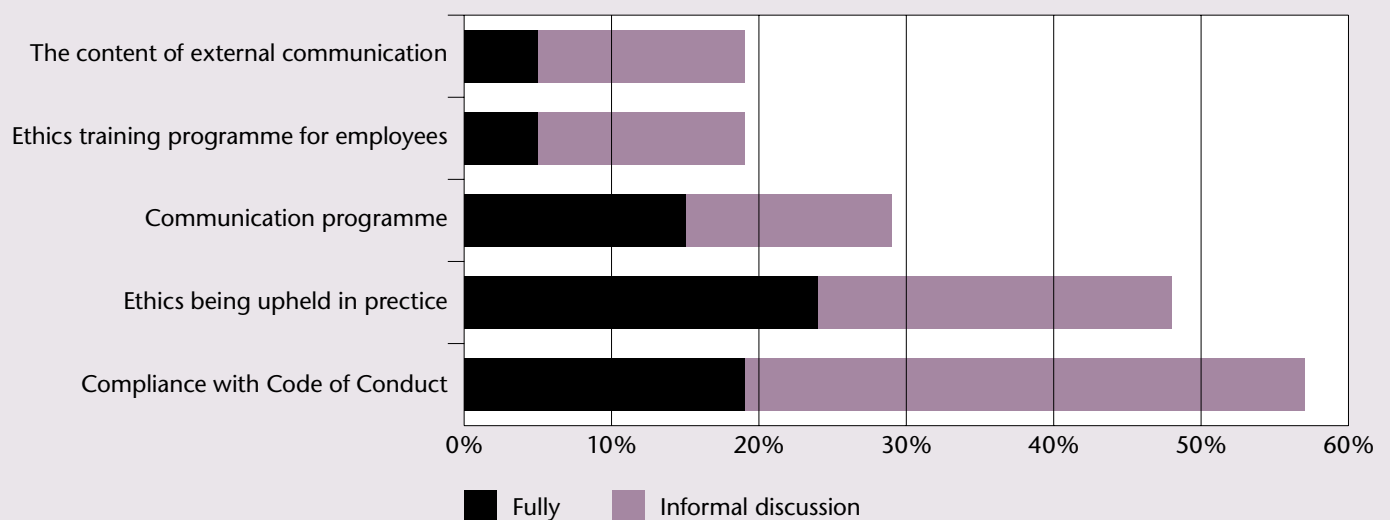
Source: Independent Audit Limited

» plan is risk based. Factors taken into account when deciding on an audit of an overseas operation, for example, range from size and materiality of the business and the significance of its inherent risks, to past audit results and the length of time since the last audit. But do your plans factor in culture? Organisational culture is often talked about as though it were uniform, but there will be local differences depending on local leadership and geography. Culture and attitudes should be taken into account more explicitly when drawing up the annual audit plan.

4. What should you do next?

Internal audit's role needs to be very clear in all aspects, including what it is doing in relation to ethics and culture. If the board has an appetite for assurance in this area, it's time to start thinking about how to provide this. The approach to providing assurance over ethics and culture is very different to traditional auditing. You're not going to find a process to map, and key

Figure 4
To what extent has internal audit been asked to provide assurance to the board or a board committee on the following:



Source: Independent Audit Limited

controls will be difficult to identify.

Rather, a more innovative approach is required, and you will need to build a picture of culture from a variety of sources and indicators: staff surveys, whistleblowing lines, staff focus groups, customer surveys and customer complaint records, supplier surveys, compliance reports, external audit comments – and, of course, internal audit findings and any specific work that internal audit does in relation to culture and ethics.

You will need to make sure you have the right skills in place to undertake a review of culture and ethics. It's highly unlikely that process skills are the right ones for this job. Instead, you'll need to ensure that you have the right soft skills and that there is the right level of emotional intelligence and lateral thinking.

And when undertaking your business-as-usual audits, consider building in specific steps to start building a picture of culture in a more purposeful way. After conducting a series of audits, you should be able to draw out important themes about culture, behaviour and attitudes. But piecing together the overall picture may not be straight-forward when different auditors are doing different pieces of work unless you've planned for this beforehand.

5. How does it all get fed back to the board? Once you've got the picture, the final question is what to say about it. Again, best check with the executive and the audit committee. It is likely that it will be inappropriate to feed back in the style of a formal and traditional audit report, so a different style of report may be required. In fact, it may be that the most appropriate reporting back will tend to the informal. The executives and the audit committee will also need to appreciate that the nature of audit evidence is not the same as for a typical audit and that views and conclusions are likely to be judgemental and based more on experience than on traditional checks.

With boards developing a greater



“Culture and attitudes should be taken into account more explicitly when drawing up the annual audit plan”

appreciation of the link between culture and ethics on the one hand, and effective risk management and control on the other, this will inevitably impact the work that internal audit is doing. How best to approach assurance in this area is evolving – but what is clear for now is that it's time to put your thinking caps on and try something different. ●

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