Does Auditing Governance Mean Auditing Culture?

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Executive Summary

- DEMAND FOR CULTURE AUDITS: Recent risk management and governance crises (e.g., Cambridge Analytica, Wells Fargo, Volkswagen, etc.).

- KEY IA POSITION/STATURE ASPECTS: Internal Audit’s position, stature, and credibility to empower/enable them to become a value-added contributor.

- INFLUENCE OF CULTURE AS DRIVER/ENABLER: How organizational culture affects Internal Audit’s role, and defines competencies needed in reviewing and monitoring risk management and governance.

Polling Question 1

Are you a Chief Audit Executive or Director of Internal Audit?

1. YES
2. NO
Polling Question 2

Have you ever done an audit of governance or culture in your organization?

1. YES, as a separate audit
2. YES, but as a smaller part of a business process/unit audit
3. NO
Polling Question 3

How would you respond to our Conference presentation title?

1. YES, indeed, Governance Audit = Culture Audit
2. NO WAY! Governance Audit ≠ Culture Audit
3. YES and NO, Aspects of Culture Audit needed
…Waxing Poetic about Culture!

“There is growing concern that companies cannot live by numbers alone… [Robust cultures] are interwoven from the interplay of a set of interlocking cultural elements:

- History yields values.
- Values create focus and shape behavior.
- Heroic figures exemplify core values and beliefs.
- Ritual and ceremony dramatize values and summon the collective spirit.
- Stories broadcast heroic exploits, reinforce core values, and provide delightful material for company events…”

Source: Deal & Kennedy, 1999
The Iceberg Analogy

Source: CIIA – UK, 2014 "Culture and the Role of Internal Audit: Looking Below the Surface" Report
But a Good Strategy Isn’t Enough!

“Culture eats strategy for breakfast.”

- Peter Drucker
5 Signs that Your Workplace Culture is TOXIC

Shelly Smith

1. “Us Against Them”
2. High Staff Turnover, Absenteeism, or Presenteeism
3. Customer Satisfaction NOT Taken Seriously
4. Promotions Based on Length of Service vs. Performance
5. Lack of Acceptance of New Ideas or Change

https://www.youtube.com/results?search_query=5+signs+that+your+workplace+culture+is+toxic
What Do Stakeholders Want?

- “Demand side” for Governance, Risk Management, Culture and Strategic Performance audits:
  - Board cares more about governance failure risk (value preservation orientation).
  - Executive management cares more about strategy/performance risk (value creation orientation).

- Majority of CAEs (57%) report that their Board or equivalent supports IA reviews of governance policies (including culture?).

- North American IA reveal lowest level of governance reviews globally!
  - CAEs perform governance audits through “little bites” strategy.
  - Some IA functions may not be mature enough to do these audits.
  - If governance risk perceived low, then risk-based audits would justify only little effort being devoted to this area.
  - Soft, Integrity Controls (Intangible, Difficult-to-Measure, i.e. CULTURE).

  Culture is both a DRIVER and ENABLER of effective governance!

Source: IIA CBOK Internal Audit Role in Governance Report, 2016
Additional Key Findings from 2016 CBOK Governance Report

- About 27% say internal audit conducts extensive reviews of organizational governance.
- Only 16% say IA conducts extensive reviews of organizational strategy or culture.
What can Internal Audit bring to the Table?

- Provide **independent, objective assessments** on:
  - The appropriateness of the organization's governance and culture structure and process.
  - The operating effectiveness of entity-level controls and specific governance activities.

- Act as **catalysts for change** by:
  - Advising or advocating improvements to enhance the organization's governance and culture structure and processes.
  - Providing assurance on the governance processes within an organization.
  - Facilitating governance and culture best practices.
IA Governance-Related Activities

➢ Governance Assurance Engagements:
  • Information integrity: relevant, reliable, timely information for strategic decision making.
  • Assuring information integrity of decision-relevant inputs, thus allowing Board/executive management to use information with confidence.
  • Typically done in “little bites” (the “nudge” approach).

➢ Governance Consulting/Advisory Services:
  • Providing decision context, interpretation, and insight.
  • Conducting comprehensive, enterprise-wide reviews to improve governance structures and processes.
  • Educating board about and facilitating governance best practices (e.g., Board self-evaluation).
## Specific Risk Management, Governance, Culture Activities

### Governance Assurance

(Helping the board and executive management use information with confidence)

1. Conduct comprehensive, enterprisewide governance audits with recommendations and an opinion (big bites) about the overall governance system, enterprise risk management (ERM), and internal control effectiveness over time.

2. Address governance as a part of assurance services for other audits (little bites).

3. Perform strategy execution reviews to ascertain conformance with the agreed-upon strategic plan.

4. Provide assurance that ERM and systems of internal control are operating effectively (as a part of the overall governance processes).

5. Evaluate entity-level controls, which would be governance controls, such as tone at the top.

6. Ensure regular, frequent open communication with the board and audit committee, including formal private sessions without management present (see the CBOI report *Interacting with Audit Committees: The Way Forward for Internal Audit* by Larry E. Rittenberg, pp. 10–11).

7. Mitigating information integrity risk, permitting the board and executive management to use decision-relevant information with confidence.

### Governance Consulting/Advisory Services

(Providing decision context, interpretation, and insight)

1. Conduct comprehensive, enterprisewide governance reviews for the purpose of providing advisory services to improve governance structures and processes.

2. Address governance as a part of consulting services for other audits (little bites).

3. Communicate recommendations to board committees, such as the audit, nominating, governance, and/or risk management committees.

4. Educate the board/audit committee about best practices for governance.

5. Provide counsel to the board nominating committee and be involved in recruiting new board members, etc.

6. Educate the board about developments and trends. Tell the board about the latest developments and trends in the industry, such as new fraud risk assessment models, new technology tools (continuous monitoring), or new pronouncements (FASB, IFRS, revenue recognition 2018, which means work starts immediately).

7. Assist with board processes and activities (for example, help with board self-evaluation processes, help update the bylaws of the board, etc.).
Risk Appetite Framework Should Be Aligned with Company’s Philosophy and Corporate Culture

- **Risk capacity**: The maximum level of risk a firm can assume before breaching constraints determined by regulatory capital and liquidity needs and its obligations, also from a conduct perspective, to depositors, policyholders, other customers, and shareholders.

- **Risk appetite**: The aggregate level and types of risk a firm is willing to assume within its risk capacity to achieve its strategic objectives and business plan.

- **Risk tolerance**: The specific maximum risk an organization is willing to take relating to relevant risks.

- **Risk target**: The optimal level of risk an organization wants to take in pursuit of a specific business goal.

- **Risk limits**: Thresholds to monitor so that actual risk exposure does not deviate too much from the risk target and stays within an organization’s risk tolerance or appetite; exceeding risk limits acting as a trigger for management action.

Source—PwC
Culture Happens by DESIGN or DEFAULT

<table>
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<tr>
<th>CULTURE</th>
<th>Drives</th>
<th>BEHAVIORS</th>
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<td>BEHAVIORS</td>
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<td>HABITS</td>
<td>Drives</td>
<td>SUCCESS</td>
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What Happens When the Culture Is Toxic

- Loss of confidence in leadership
- Groupthink and judgment errors
- Unethical or illegal behavior
- Erosion of the brand and reputational damage
- Erosion of shareholder value

Remember? “Culture eats strategy for breakfast.” - Peter Drucker

Source: Richard Chambers—GAM March 2016
Potential Internal Audit Governance/Culture Involvement

- Participate in cross functional “what if” discussions to reconsider governance risks and identify action plans.
- Help design “how to improve governance and cultural processes” to better address risks.
- Redirect audit resources to re-assess highest risk areas:
  - M&A activity on target to exceed $5 trillion globally in 2018 underscoring the importance of governance reviews (WSJ, July 2, 2018).
  - Risk assessment and risk management/monitoring practices.
  - Complex decision models—relying on information—the relevance of “information integrity risk”.
  - Culture, strategy, IT governance.
  - Fraud risk management and loss prevention.
  - Extended enterprise reviews.
- Internal audit review of organizational governance and culture (assurance and advisory engagements).
CULTURE - Communication & Engagement

➤ Align – Make It Clear
➤ Understand – Make It Known
➤ Define – Make It Real
➤ Implement – Make It Happen
➤ Track – Make It Stick

Adapted from “Culture and the Role of Internal Audit” KPMG, by Keele and Dalton
Strategies for Auditing Risk Management Culture

- Identifying culture as the “Root Cause” in Individual conclusions/findings
- Audits of culture within lines of service, business units, or geographies
- Issuing capstone or theming reports based on multiple inputs
- An enterprise-wide assessment of culture

Source: Richard Chambers—GAM March 2016
Auditing Culture

Culture—“the way we do things around here” (Bower)—embeds many intangibles, e.g., “soft controls” that pose audit challenges:
• Management and board competence, philosophy, and style.
• Mutual trust and openness.
• Strong leadership and powerful vision.
• High performance and quality expectations.
• Shared values and understandings.
• High ethical standards.

Strategies for Addressing Culture:
• Communicate with senior executives about their views of governance culture.
• Develop trust with the audit committee that allows subjective judgments.
• Find a champion who supports auditing organizational culture.
• Define roles of what IA can realistically do to help improve organizational governance.
• Consider incorporating governance audit into IA charter.

Use UNOBTRUSIVE TECHNIQUES™ to audit culture!
# Framework for Organizational Culture Assessments

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<tr>
<th>Theme</th>
<th>Areas of Emphasis</th>
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| Mission, Vision and Values    | • Tone from the Top  
|                               | • Risk culture and accountability  
|                               | • Communication practices  
|                               | • Policies and procedures                                                    |
| Risk Management               | • Governance framework and risk orientation (e.g., ethics/whistleblower policy)  
|                               | • Risk Transparency  
|                               | • Risk Tolerance  
|                               | • Risk Response (e.g., agility and resilience)                                |
| People/HR Management         | • Employee lifecycle management  
|                               | • Incentives and rewards  
|                               | • Training and competence  
|                               | • Crisis response preparedness                                                  |

Source: Adapted from Protiviti Bulletin Volume 6, Issue 12
Practical Considerations: Lack of Support in Auditing Culture Can Be a Hurdle

Has full support of the board to assess all levels
- Strongly Disagree: 1%
- Disagree: 17%
- Neither: 34%
- Agree: 43%
- Strongly Agree: 5%

Has full support of the executive management to assess all levels
- Strongly Disagree: 3%
- Disagree: 13%
- Neither: 19%
- Agree: 38%
- Strongly Agree: 27%

Has freedom to assess the entire organization & staff
- Strongly Disagree: 2%
- Disagree: 10%
- Neither: 12%
- Agree: 43%
- Strongly Agree: 33%

Source: Pulse of Internal Audit, 2016. CAEs/Directors, North America - Q12
How an Organization Responds to Internal Audit Says a lot about Culture

- How receptive is management to an audit of their area?
- How open and cooperative is management during an engagement?
- How receptive and responsive is management to findings and recommendations?
- POLITICS, or the way power is distributed within and across organization is a key consideration (e.g., Rittenberg & Smith 2015).

Source: Richard Chambers—GAM March 2016
How Do You Handle a Toxic Work Culture?

Simon Sinek

https://www.youtube.com/watch?v=0cgCFxL7Nvo
Polling Question 4

How receptive is your management regarding an audit of governance or culture in your organization and in supporting your recommendations?

1. Very supportive and receptive
2. Somewhat supportive and receptive
3. Not supportive and receptive
Assess Internal Audit’s Skills and Fill the Gaps

- Need ability to identify and assess hard and soft measures of organizational culture.
- Need to combine subjective and objective information.
- Be confident in relying on qualitative factors or intuition.
- Not be reluctant to think out of the box and share good practices from other organizations.

Only 45 percent of CAEs who don’t audit culture agreed that they are able to identify and assess measures of organizational culture.

Embrace and execute a risk-based approach:
• Availability of resources with relevant subject matter expertise, industry knowledge, leading practices, tools and technology.
• Boards fear that potential cultural risks may not be addressed.

Better overall process:
• Higher expectations from management and AC time/resource constraints on Internal Audit.

Better risk management leadership:
• Getting the right input from top management and the Board.
• Enhancing top management/Board risk management capabilities.

Better knowledge of limitations:
• AC’s and management’s level of understanding of the Internal Audit function.
Enduring Insights from Anthropologists

“No two people do things exactly alike, and no one lives by the rules all the time...

Thus, there are various levels of rules or systems:

- things people say they do;
- things they say they should do;
- things they really do; ways they bend the rules without actually breaking them;
- ways they break the rules and get away with it;

and the ways they feel about all this.

(Benderly, Gallagher & Young, 1977; cf. Shakespeare’s remark about “More honor’d in the breach than the observance” in *Hamlet*, Act 1, Scene 4)
Stakeholders will look to internal audit to help focus on governance and culture improvement; but internal audit needs to be trusted advisor/guide!

- Maintaining an ethical organizational culture and tone from the top could be challenging for the board of directors.

- Board members need to recognize their responsibilities in this area.

- Internal audit can help by educating, providing information on what to look for, and how to recognize red flags related to culture.

- Consistency, clarity, communication, and monitoring are critical actions for board members to better reinforce ethical organizational culture.

Source: Journal of Accountancy, July 2018
Additional Useful References

- Turning Corporate Culture Into a Competitive Advantage, Robert Half/Protiviti 2018.
- The IIA Bookstore—Various books, other publications, and thought leadership on Governance and Corporate Culture.
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Thanks for your Attention!

QUESTIONS/COMMENTS?