DOES AUDITING GOVERNANCE MEAN AUDITING CULTURE?

Internal audit can be a key player in giving confidence to a wide swath of stakeholders that the measures that are put in place to change culture and behavior are actually working.

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According to the definition of internal auditing in The Institute of Internal Auditors' (IIA's) International Professional Practices Framework (IPPF), internal auditing is an independent, objective assurance and consulting activity designed to add value to and improve an organization's operations.[1] The IPPF goes on to address internal audit's role in the review and evaluation of internal controls, risk management, and governance processes. Since The IIA's founding in 1941, there has been a gradual shift in the focus of internal audit activity from a preoccupation with compliance and internal controls to a broader role that

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includes enterprise risk management. One of The IIA's newer certifications, the Certification in Risk Management Assurance, is clear evidence of this trend. Along these lines, audits of governance structures and processes, including organizational culture, is the newest frontier.

Recent corporate governance scandals and disasters have contributed to this shift of focus as they have caused organizations to scrutinize and adjust their own governance structures and processes. Ensuring that an organization has a sound governance structure with effective and ethical policies and practices, along with decision-relevant information that is accurate, reliable, and timely, is critical to the organization's success. These factors, including an emphasis on transparency and accountability, impact the organization's reputation, stakeholder satisfaction, and overall growth and profitability. Consequently, more companies are seeking assurance that their governance structures are sound and are often turning to internal audit for help. The role that internal audit should play in the process, however, is diverse and varied based on the maturity of the function, its independent status and credibility, how seasoned the internal audit professionals are, the size of the function, the organizational culture, and the support of the Board and management in including a governance audit as part of the internal audit charter and mandate.

Boards, audit committees, management, regulators, employees, and shareholders are all among the group of stakeholders who seek assurance about the information they use for strategic decision-making and that an organization's governance system operates effectively to achieve objectives and increase company profit and growth. Some organizations do turn to internal audit for such assurance, particularly those with larger and more sophisticated internal audit functions. It is, therefore, important that internal audit seeks opportunities to identify and communicate governance risks and advise on best practices to the appropriate parties. Indeed, executives, boards, regulators, and investors seem to have taken note of the importance of culture. According to KPMG's U.S. CEO Outlook 2017 survey, 81 percent of CEOs are increasing their focus on trust, values, and culture to be competitive long-term. Further, reputational and brand risk was rated as a top risk by CEOs in 2017, although it did not feature as a top risk in 2016.[2]

ALONG THESE LINES, AUDITS OF GOVERNANCE STRUCTURES AND PROCESSES, INCLUDING ORGANIZATIONAL CULTURE, IS THE NEWEST FRONTIER.

Despite the increasing need for internal audit to be involved in governance reviews and audits, the actual role that internal audit should play in this process has yet to be formally defined.[3] Similarly, a set playbook on how to audit culture does not exist at this time, and therefore procedures must be tailored based on the organization's culture, maturity, and appetite for improvement, internal audit's capability and ambition, and support from executive management and the Board.[4]

Common Body of Knowledge Core Report on internal audit's role in promoting and supporting effective governance

As part of The IIA's Common Body of Knowledge (CBOK) global survey undertaken in 2015, Ramamoorti & Siegfried co-authored a report on internal audit's role in organizational governance.[5] Specifically, they noted that internal audit's role in organizational governance has become increasingly important in the wake of the recent global financial crisis and the continuing spate of governance failures in both financial and public sectors throughout the world. Informed observers and commentators have asked:

1. "Where were the external auditors?"
2. "Where was the audit committee?" and more recently,
3. "Where was internal audit in all this?"

The CBOK report draws on survey responses from internal auditors in 166 countries to take stock of the role of internal audit in the governance process and learn how internal audit can better position itself to contribute to effective organizational governance. Key findings from survey respondents include:

- Only 4 out of 10 say a governance code is in place at their organizations;
- In contrast, more than 6 out of 10 say their organizations have a long-term strategic plan in place;

- About 27 percent say internal audit conducts extensive reviews of organizational governance; and
- Only 16 percent say internal audit conducts extensive reviews of their organization's strategy.

Based on our review of surveys and professional literature on this topic, we believe that internal audit is well positioned to promote and support organizational governance and thus help achieve a balance between value creation (profitability and growth) and value preservation (sustainable, long-term performance). In our considered opinion, governance reviews give internal audit the opportunity to help prevent governance failures and improve strategic performance. Thus, it is critical that we seek to better define the role of internal audit in the governance process and that internal auditors continue to adapt and evolve globally to take advantage of these opportunities.

Culture underpins strategy, governance, and risk management

One common underlying factor that drives value creation and value preservation efforts is organizational culture. It is fair to say that organizational culture has a pervasive and critical influence on organizational success, achievement of superior governance outcomes, and the degree of significance or involvement of internal audit in helping achieve those outcomes. In other words, auditing governance structures and processes is incomplete and fundamentally flawed if appropriate attention has not been given to considering organizational culture. However, it may be that culture is assessed and evaluated in different ways: It may be integrated as part of the audit; separately assessed then factored into the overall governance audit; undertaken in "little bites" so as not to overwhelm the people in the organization; and in particular instances, even undertaken in an unobtrusive manner to be most effective.

Conceptually speaking, we first need to understand the key terms that are relevant for auditing culture as highlighted by KPMG partner Tracey Keele in her 2017 AGA presentation.[6] There is the "soft stuff" consisting of values, leadership, mindset, behaviors, informal practices, and norms; the "hard stuff" comprising processes, policies, and systems; and finally, "culture," defined naturally and intuitively by the long-time McKinsey & Co. Chairman, Marvin Bower, as "the way things are done around here," that is, the impact of the "soft stuff."[7]

IIA President and CEO Richard Chambers focused on organizational culture in his 2016 General Audit Management Conference presentation titled "When Culture is the Culprit."[8] He explained that there are both hard controls and soft controls that can be audited when the internal audit activity is looking at organizational culture.

INSTEAD, IT IS CRITICALLY IMPORTANT THAT CULTURE AND STRATEGY ARE ALIGNED AND WORKING HAND-IN-HAND.

First, there are hard controls that can be audited to help improve organizational governance:

- codes of ethics/conduct;
- human resources policies and procedures;
- other policies, rules, and defined procedures;
- organizational structure; and
- defined roles, responsibilities, and authorization levels.

Auditing these hard controls is within our comfort zone, and some internal audit functions do routinely conduct these types of audits. Thus, it is often not difficult for internal audit to add some value to the governance processes by auditing these areas. The challenge arises when significant judgment must be used when trying to audit the soft controls.

In particular, it is instructive to draw attention to the late Peter Drucker, respected management guru, who remarked, "Culture eats strategy for breakfast."[9] No matter how well thought out the strategy is, if you do not have a positive, healthy culture, or do not consider the culture in your organization to support strategy, your efforts are unlikely to succeed. Indeed, many business leaders have underestimated the power of culture and failed in their strategy implementation because they ignored the organizational culture's relevance and impact. Thinking about "strategy versus culture" is posing a false dilemma; it is not an "either/or" question. Instead, it is critically important that culture and strategy are aligned and working hand-in-hand. If a company proposed a new strategy that deviated from the current mode of operation, it would require significant change in the employees' thought processes and behaviors to translate that strategy into action. This significant point has been reinforced in the 2017 update to COSO-ERM, "Enterprise Risk Management; Integrating with Strategy and Performance."[10]

The meaning behind Drucker's quip is simply that we should not ignore culture or take it for granted. Instead, we must plan for it, recognize its value as a driver and an enabler, and make it work, particularly when auditing governance structures, processes, and practices.

Culture is embedded with many intangibles, including soft controls. Some of the soft controls that can be audited to help improve organizational governance include:

- 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; and
- high ethical standards.

Rather disappointingly, these are areas that most internal auditors lack experience in auditing and for which there are fewer formal tools and training. Assessments of soft controls tend to be less analytical and more interpretive. In the absence of appropriate transparency and accountability metrics, auditing soft controls can prove to be an uphill task.

AUDITING SOFT CONTROLS HAS PROVEN TO BE MUCH MORE CHALLENGING.

There are times when addressing culture becomes urgent, particularly when the culture has become toxic. The IIA's 2016 *Pulse of Internal Audit Survey* in North America asked CAEs how they would address a "toxic culture" in their organizations.[11] The option they say would be most effective in this situation was "raising culture as a separate topic with the board or audit committee." 62 percent say this is a very or extremely effective way to address a toxic culture. The weakest support went to "focusing on organizational culture issues in audit reports" (21 percent), perhaps indicating the perspective that in a very dysfunctional environment, issues need to be addressed at the top rather than through the normal processes of auditing.

Finally, it is important to get everyone on board and set the appropriate expectations for internal audit to perform governance audits. To achieve this, the following are recommended as good first steps:

- Communicate with senior executives about their views of governance culture so that the internal auditors better understand stakeholders' expectations;
- Develop trust with the audit committee, which will allow subjective judgments;
- Find a champion who supports auditing organizational governance culture;
- Define the roles of internal audit in helping to improve organizational governance; and
- Consider incorporating governance auditing, including the auditing of culture, into the internal audit charter.

We believe that if these steps are followed, it will be much more likely and possible for internal audit to get involved in effective organizational governance auditing that will help prevent governance failures and help improve the organization's strategic performance.

In addition, both the governing body and internal audit should recognize that organizational culture is a key driver and enabler of both successful performance and effective governance outcomes. Typically, business processes, internal controls, and policies and procedures feature hard controls, while organizational culture, by definition, is distinguished by many intangibles and behavioral issues that necessitate soft controls. However, auditing soft controls has proven to be much more challenging. Auditing organizational culture can be accomplished by conducting culture and ethics audits using ethnographic surveys in a global organization. These audits take the pulse and temperature of the organization with respect to assessing the health of its culture and ethical climate.[12]

Organizational positioning, stature, and credibility of the internal audit function are also undeniably important in the context of conducting governance audits and reviews. It is extremely important for CAEs to excel at "relationship-building acumen" and communication skills and be adept in undertaking and executing governance reviews and audits competently.[13]

Conclusion

Due to the recent series of governance failures, the auditing of governance structures and processes has become a resurgent theme in organizations around the world. It therefore seems inevitable that both organizations and internal audit will recognize stakeholder expectations and gradually expand the scope and range of their activities to include culture as an integral element of the auditing process. Looking to the future, as organizations come under increasing pressure to demonstrate their commitment to improving standards of behavior (for example, consider the oversight role of the Financial Conduct Authority with respect to the financial services industry in the U.K.), internal audit can be a key player in giving confidence to a wide swath of stakeholders that the measures that are put in place to change culture and behavior are actually working and that the tone from the top is appropriately reflected at all levels.[14] Our answer to the question posed by this article is an emphatic "Yes," and any governance audit that does not naturally evaluate organizational culture is incomplete.

In particular, we surmise that there will be an expansion of the traditional backward-looking financial reporting emphasis and reliance on external audits to include a forward-looking position focused on strategic operational and performance data that will increase the involvement of internal audit for more effective monitoring and governance oversight. The emerging future governance landscape presents exciting opportunities for internal audit to add value by conducting governance audits and reviews, auditing hard and soft controls, and promoting and supporting effective organizational governance. ■

NOTES

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