

ViewPoint

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Controls

Markets need the
missing piece of
controls jigsaw*

An incomplete picture

Regulators in the capital markets have responded to headline-grabbing corporate failures by increasing the focus on controls. Most of the regulatory initiatives have focused on the processes of control and documentation. The most visible example is Sarbanes Oxley, which has resulted in corporate officers certifying their responsibility for a business's key controls and verifying their effectiveness. This is an enormous undertaking, and entails huge costs for businesses and their stakeholders.

Regulators believe this focus is vital to reassure the capital markets that all is well with the fundamentals underpinning business practice. But for many these steps may not be enough. Whilst control processes are an important component of the overall control environment, they alone will not prevent further corporate failures. All our experience as auditors suggests that there is a missing piece in the controls jigsaw: the corporate culture. This is the set of sub-conscious influences that shape employees' behaviour. It is our view that, if the work on control processes is to have real value, greater insight into the culture of an organisation needs to be provided to the capital markets. This includes an understanding and evaluation of the factors that drive behaviours and determine the culture. And it is the culture that will, to a great extent, determine how people interpret, and act upon, information that is provided through the controls process.

Why is corporate culture so important?

The reason why corporate culture is so important stems from the fact that corporate failure arises in a large part through dishonest management, or cultures of fear and arrogance.

These factors influence how information is seen and colour decision-making.

At the heart of the issue are the judgements people make, and the actions that stem from those judgements. For instance, when presented with information that shows underperformance, what is the employee's likely reaction? Tell the boss now; wait for another month; bury the information; hope he doesn't notice or manipulate it slightly? These decisions can be viewed as part of a continuum, with fraud – the deliberate overriding of process – at one end of the spectrum and a simple error or poor judgement at the other. Our experience suggests that extreme behaviour which results in fraud – for which no level of assurance will provide full protection – will be facilitated by an unhealthy culture. An organisation will tend towards this extreme where decision-making is susceptible to influence, bias and a pre-conditioning created by a poor prevailing organisational culture.

In fact, the very systems that are put in place to improve the controls may be exacerbating the problem. As companies streamline their organisations, with leaner business processes, technology inevitably plays a greater role. Unless the impact of this change on the people is considered there is a risk of alienation, where the person feels part of the system, rather than being treated as an individual. This in turn will drive deterioration in the culture. The very system that has tightened the control process has inadvertently damaged the culture and potentially the overall effectiveness of the controls.

Without gauging what factors influence the judgement of the decision maker, any understanding of the effectiveness of controls is incomplete. Without this understanding the markets lack critical information to judge performance and make their own assessment of a business's sustainability. The reaction of the markets to

reporting on the control process will provide insight only into the value placed on the process. How much stronger would that reaction be if there were some insight into a business's culture of control?

What aspects of culture are already assessed?

The COSO framework (see box) is the tool most widely used to evaluate an organisation's system of controls. And the increased emphasis on controls has brought it to centre stage.

The framework considers five interrelated components:

- the control environment
- risk assessment
- control activities
- information and communication
- monitoring

The first of these, the control environment, establishes the overall tone and sets the foundation for all control activities. But in all too many cases it is the governance that is assessed – the creation of, and compliance with, rules – rather than a close analysis of the factors that influence behaviours within that organisation. Is this a reflection of the difficulty in assessing the less tangible elements of the environment?

However difficult this issue may be, it is not ignored by auditors and investors. Through their interactions they assess the behavioural influences in businesses in order to determine the quality of management. Within our profession, our interactions with the board, the finance group and operational areas provide us with a unique view of the business. But this assessment is used only to shape the work we do – it is not a formal part of the audit, it is not discussed with the audit committee and it is not disclosed externally.

Control processes are a critical component of the control environment, but they alone will not prevent further corporate failures

In 1992, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) developed guidance for dealing with internal controls. The objectives of this framework are to ensure and improve the effectiveness and efficiency of the operations of a company, the reliability of their financial reporting and compliance with laws and regulations. The main elements of this framework are the enterprise-specific control environment, the respective risk assessment, the related control activities, the appropriate information and communication and finally the monitoring by the management. The aim is to gain a common understanding of the overall business environment, to be aware of the risk which could hurt a company and to implement an appropriate, effective and efficient internal control system in order to respond to risks and identify opportunities. In 2004 COSO issued a second framework which extends to Enterprise Risk Management with a more active management and response to risks, regards non-financial information and refers to the overall strategy of a company. Both frameworks however, are models. They have to be underpinned by concrete actions.

What influences behaviour?

To understand the culture of an organisation we need to be able to assess and analyse the main influences on behaviour. Of course, behaviour is complex and multi-faceted but in the corporate context there are three main influences:

- Leadership team behaviour
- The apparent values of an organisation
- Emotional influences on decision-making

Let's consider each of these areas.

Following the leaders

The people in power set the agenda and implant and perpetuate organisational culture. Although they are not fully responsible for determining the underlying culture, they have significant influence both on maintaining the existing culture or helping the organisation move towards a new one. Such is their influence, it is vital that the board comprises people with the appropriate skills, integrity, judgement, competencies and values. Corporate officers also need to bring previous business experience to the table, and in particular their knowledge of the differing demands of a business as it progresses through its growth cycle. This applies to both non-executives and executives. Recognised experience generates respect and confidence both inside and outside the organisation and provides a strong platform for the leadership team to influence behaviour.

A board with the right experience, balance and mutual respect will be best placed to set the tone from the top down. So what are the key features we should be looking for? A robust relationship between the CEO and the chairman, where challenge and debate is the norm. A balance of personalities, skills and background. Clarity on roles and responsibilities. Above all, the team needs to be aligned with the agreed strategy and act constructively to provide strong, consensual, leadership.

Where the board fails to work as an effective unit, the converse is true. Here we often see dominating behaviour, no challenge or debate and personal agendas being played out which more often than not do not align with the overall strategy. This can lead to ineffectual leadership and uncertainty and, ultimately, poor performance in the organisation.

Strategy at the centre

The strategy provides real insights about the effectiveness of leadership. Are the leadership team and the people within the organisation clear about where they are heading? Do they have a sense of shared purpose and direction? Without clarity there is scope for disagreement on priorities and objectives. This, in turn, leads to a lack of understanding about individual objectives and responsibilities, and creates the environment in which critical issues can be ignored or suppressed. Without shared objectives it is difficult to direct and influence from the top.

Having created a clear strategy and set of objectives, the next challenge facing the team is to deliver them. Are they capable of clinical execution or are they fumbling in the dark? Strong leadership with clear accountability aligned to responsibilities provides focus for the delivery team. Clear communication of objectives, with constant review and feedback on performance, combined with an open culture that encourages innovation, allows healthy change to be driven throughout the organisation.

Making honesty and transparency the norm

And how are decisions made and risks managed? The appetite for risk communicated from the top will set the context for decision making. However, within this context it is the quantity and quality of information available and the nature of the decision-making process itself that will influence behaviours.

Is there a real or perceived view that anyone bringing bad news will face a "shoot the messenger" culture or, equally poor, be totally ignored? In this case, even with controls in place, the failure may not be conveyed to the board. This was the case with a recent corporate fraud where there was repeatedly no escalation of significant issues. This led to incomplete and incorrect information being presented to the board. Naturally, the board acted on this information in good faith but the culture of the organisation – with the tone set from the top – had already damaged the effectiveness of the controls. This can lead to a downward cycle as poor information causes a breakdown in the decision-making process and results in poor behaviour. Decisions lack rigour, they are made outside formal channels and when unforeseen risks arise, there will be a lack of ownership for the decision.

When bad news eventually reaches the market – as it inevitably does – the cultural issue behind it can influence the market more than the news itself. This is a sure sign that the market is tuned into the cultural issues behind performance and reporting.

How the board operate as a team will influence the culture by setting the tone for the organisation. Similarly, leadership is critical in establishing the values of the organisation. This applies to the process of determining and communicating the formal values, but more important are the values that the leadership and the rest of the organisation actually live by.

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What are values worth?

The values of an organisation form an invisible but all-embracing influence. They create an organisation's 'feel' or reputation, as judged and reinforced by a wide range of internal and external stakeholders. They inform accepted behaviour and norms within an organisation. They reflect the dos and don'ts. They determine whether the organisation is viewed as a thriving ecosystem or one that is polluted at source.

There are often unspoken rules that drive behaviour. For instance, there might be a culture of "don't question your boss" which restricts healthy challenge and innovation. Similarly, there may be a degree of anarchy which supports the maxim that "rules are there to be broken". Arrogance and aggression are commonly cited where failure occurs, behaviours which typically result in controls being overruled and ignored – both are clear warnings about the culture and the implications for the business.

Most organisations have a feel about them. Today it is commonplace for companies to have a published set of values. But these are worthless if they're not implemented consistently or if, through observed behaviour, it is apparent that the company operates to another set of values – a set which is clearly different to those it purports to uphold. Without aligning the values within an organisation the influences on behaviour will be inconsistent and can lead to the creation of discrete sub-cultures. This often happens when integrating different cultures into one organisation following a merger or acquisition.

How the market perceives an organisation is determined by a cocktail of influences. Yes, investors and analysts meet management face-to-face and form views based on these interactions. But this picture is then reinforced or compromised by what others say based on their dealings with the organisation. Customers, suppliers and competitors will all have their own views as they glimpse the organisation's culture through their business dealings. When these groups and others exchange their views and blend them together, with

the media adding to the mix, the overall perception can be potent. It can act to reinforce the reputation of the organisation (whether good or bad), and, in turn, shape the behaviour of those interacting with the organisation as well as those who work inside it.

Furthermore, these influences and perceptions spread beyond the business world. Employees of the company represent it in and out of work. Again, the actions of those in the limelight, the leaders, have the greatest exposure and the greatest impact. In some cases the values can be strong enough to drive their behaviour, good or bad, outside the work environment. However, it is within the work environment where there are explicit factors that reinforce and drive individual behaviour: the motivation behind their actions.

Hearts and minds

What motivates and drives individuals when they make decisions? Performance targets are critical to drive change through a business. But a misplaced target can just as easily push the business off-course by encouraging people to behave in a manner which is inconsistent with overall business objectives. Targets must align with a number of key performance indicators that will create a sustainable business. Individuals should be rewarded when they reach those targets.

Increasingly, we see shareholders challenging excessive executive pay relative to performance. This is particularly so where value is deemed to have been destroyed. These challenges force management to think longer term, beyond simple sales and cash targets, to embrace the strategic fundamentals of the business. In turn, this will influence individuals throughout the organisation to make decisions that align with longer-term performance goals rather than short term, often personal, gain. This short-term thinking has been evident in cases where the scale of a potential bonus has driven an individual to make decisions that have threatened the existence of an entire company. We are all aware of a number of high profile examples of traders doing exactly this.

The precise nature of motivators and the judgements they encourage are vital in determining where a business sits on the decision continuum. Do the motivators drive a business towards the fraudulent end where it is accepted practice for information to be withheld or manipulated? This can be seen in situations where the application of judgement is exercised to deliver results the market wants to hear rather than the true story. This behaviour may finally manifest itself in a pattern of fraudulent reporting which enslaves, and eventually ensnares, the business.

Much of the balancing of decisions should lie with the finance department. However, the standing of the department heavily influences how people respond to the controls it oversees. Do people respect the department and see it as a key element in the decision-making process? Or do they perceive it to be a bureaucratic hurdle to clear – 'the bean-counters' – rather than the conscience of the company?

The standing of the department is therefore key in influencing the decisions made in financial reporting. A strong and objective finance department and CFO lead to balanced accounting policies. In turn this type of department provides the basis for an organisation to have a strong control 'conscience' with tight budgetary discipline and compliance controls. In contrast, where the CFO and the department lacks the necessary independence and stature required to face up to the CEO, we see aggressive behaviour aimed at destabilising and overriding controls, for example, increased complexity in financial products designed to disguise the financial structure of the business. In such a culture complexity is viewed as a virtue and justified because "everybody does it".

So, motivators can significantly influence decision makers towards both good and bad behaviour. The challenge is to understand how motivators influence behaviour within the context of all behavioural influences.

Insufficient insight
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Bringing culture to market

We have discussed how leadership, values and emotional influences can change behaviours positively and negatively. Not surprisingly we tend to focus on the corporate failures which have been so prominent in the headlines of recent years. These instances are the extremes, where behaviour has led to near or actual failure. But what about the cases where poor behaviour leads to, less sensationally but more likely, sub-optimal performance? In some cases this might indeed be a precursor to eventual collapse. But in the interim shouldn't investors and analysts be able to recognise the evidence, shouldn't they be in a position to tell the difference between a decaying culture and one that is sustainable?

Without better information and the ability to monitor these factors, the effectiveness of controls cannot be adequately assessed, whatever the procedures and reporting dictated by the regulators. This thinking has led some commentators to question the real value of the effort and cost of reporting comprehensively on the control process alone. Would greater insight into the culture not provide a more complete and valued picture of the control environment? As effective controls are the foundation of reliable communication with the market, insufficient insight into organisational culture is a source of significant risk in our capital markets.

Who leads the charge?

First, analysts and investors need to be clear on what information is needed to make an objective assessment of this critical area of business performance. In turn, this needs to be balanced with the ability of the company to provide it. By nature this is information that cannot readily be, and should not be, regulated. This leads us to the second point.

Regulators need to be aware that there is little value in piling on further regulation around the process of control without the markets having greater insight into organisational culture. If anything, more regulation conceals further the culture

as additional layers are added that need to be peeled away before revealing an organisation's heart and soul.

Thirdly, there is significant work for boards and particularly non-executives in this area as this is fundamentally an issue of governance and effectiveness. Greater transparency in the way the board operates, their values and their decision-making processes provides insight into the tone they set for the organisation. Better reporting on strategy and risks provides greater comfort on the quality of the board, its leadership and understanding of the business, and ultimately its ability to perform.

And finally, what role can we as auditors play? As discussed, through the interactions we have with our clients we already make an informal assessment of the culture and the effectiveness of the board to make our judgements and help determine the scope and nature of our work – this is our profession. We are expected to comment to boards and independent directors on an informal basis though the boards may wish to seek independent assurance for the markets. We might also be well-placed to validate any reporting by companies on their culture but beyond this we alone cannot do much more. Ultimately we believe that reporting on the culture should be an integral part of internal control reporting. Whether this informal assessment should be made more formal is something for the audit profession and others to consider and is inextricably linked with professional liability issues.

How can we move forward? One option – and our preferred solution – is to join up all the parties discussed with other stakeholders in the capital markets to bring together their views, experience and different agendas to address the issue. This would bring experiences, research and insight into corporate failures together, with the intention of creating practical guidance and recommendations for the participants in our markets.

The second option is to allow the markets to interpret culture through the increasingly broader scope of corporate reporting.

Reports on strategy, remuneration, governance, relationships, to name a few, provide a degree of insight into the organisation. When combined with the increased reporting on controls this may go some way to filling the gap in the jigsaw. However, our main concern is that this informal approach is subject to the pace of development and quality of reporting and will always be subject to a large degree of interpretation.

This issue is too important to leave open. Until all stakeholders have a greater insight into organisational culture, there remains a significant gap in the information required for the markets to be assured of the effectiveness of controls. Without this piece of the puzzle the value of regulating process is significantly diminished, certainly when considering the cost of compliance. If it could be combined with some ability to gain insight into the culture, that value would be restored. Clearly, it cannot remain this way and the markets must work together to provide the right approach and framework to look at things in a new way.

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