



cutting through complexity

Internal Audit – The 360°
**Measuring the
immeasurable –
internal audit and
organisational
culture**

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Culture is a hot topic in auditing circles in the UK. Increased regulation of the financial services industry has turned the spotlight on to the impact of culture on the performance and behaviour of financial services providers in particular. Board members and non-execs are asking questions about culture that they wouldn't have raised even 12 months ago.

What does this mean for internal audit teams? They are having to step up to the task of auditing culture in financial institutions. This presents some obvious challenges as culture is typically intangible and hard to measure.

KPMG's internal audit specialists have taken a look at the issue of culture in internal audit, how best to approach it, what it is and how the regulators can help or hinder the progress and development of effective auditing procedures.

We asked our colleagues whether they thought that internal audit should include culture in its scope, and also whether there were any definitive indicators of good and bad culture. The following articles are their personal opinions, and provide a spectrum of ideas around auditing culture.

Katie Clinton, KPMG Audit Partner, leads with a call for greater clarification from the CIA (Chartered Institute of Internal Auditors) of what makes for an effective cultural audit.





Katie Clinton

“ The CIIA needs to further define what is expected in an audit of culture, what areas need to be covered and what might be the outcome. ”

Regulators have recognised the need to audit culture within financial services following the shockwaves from scandals including PPI mis-selling and Libor. I think the CIIA are absolutely right to issue guidance to internal audit teams on cultural audit as a result. However, I believe its guidance does not currently go far enough.

The CIIA needs to further define what is expected in an audit of culture, what areas need to be covered and what might be the outcome.

By creating a clear model for a cultural audit, the CIIA can help financial firms and auditors move away from tick-box exercises which some IA functions currently undertake. These can often be more damaging than doing nothing at all, because they offer a false level of assurance.

It should be a given that culture needs to be considered as part of internal audit, but professional advisors need to be trained in understanding and recognising what that means. The CIIA are starting to offer courses in auditing culture, but I believe this training must be industry specific.

Different industries will have completely different cultures, which throw up quite different indicators and challenges. An auditor of a factory will not be looking for the same cultural indicators as an auditor of an investment bank.

To be fair, the CIIA are only issuing guidance. Some responsibility for ensuring effective cultural monitoring must fall on the banks themselves. The fines that have been imposed in the wake of financial scandals have alerted a lot of the UK-based institutions to the need to put culture at the heart of what they're doing, but many international banks have yet to do so.

I would estimate less than 20% of organisations have actually defined what good culture is. As a result, the reaction of many organisations to being told they must deliver a cultural audit is to implement a two or three week process to assess culture, with very little to measure against.

There are some honourable exceptions, mostly large domestic organisations, including a leading bank which checks every new product against its values to see that it measures up. It is the boards of these institutions that need to define culture. They need to then communicate it clearly by having a single written statement. It might feel a bit woolly, and clearly you're not going to define every possible action, but in a similar way to a risk appetite statement, it can help to set some boundaries.

Once culture is effectively defined, then auditors can measure how well it is embedded within an organisation through a process of continuous assessment. Culture can change over time, and needs to be more subtly assessed than with a straightforward red, amber or green.

In a similar way to auditing for fraud, culture needs to be in the back of an auditor's mind during every audit.

Changing attitudes to the importance of culture throughout the financial services industry will take time. The CIIA could mandate that all financial services firms do four cultural audits a year, but if there's no clear understanding of the objectives or of the definition of culture that they are assessing, these are likely to be four audits that may lack value and be potentially misleading. This is all the more reason for the CIIA to give a further push in the right direction by issuing more definitive guidance and a clear model of best practice.

Albert Camus said, 'Without culture, and the relative freedom it implies, society, even when perfect, is but a jungle.' Although he was more likely talking about art and literature than financial services, it feels apt here too. A definition of culture and a model of best practice would undoubtedly be a step in the right direction. Culture itself covers a variety of broad and often intangible aspects within business. Helen Charnley, KPMG Director in Internal Audit, reflects on which aspects of culture we should be auditing, as well as the need for business support for their internal audit functions.



Helen Charnley

I think it's essential that internal audit includes culture within its scope, but while culture in its wider sense relates to accepted behaviours within companies, I think we need to look at risk and control culture in particular.

It is imperative that the wider company culture supports a business's risk and control framework. Many companies invest hugely in designing a strong control framework, but struggle to embed it because accountability and control are counter-cultural. It's no good having a world class control system if it is undermined by a feeling of, 'Well, that's what it says, but actually what we do and what I'm rewarded for is...'

By extension, this attitude of support is necessary for the success of internal audit itself. Internal audit can flag problems and make recommendations as much as they like, but if the board only pay lip service to controls, then no remedial action will be taken.

Some companies may have hundreds of overdue internal audit recommendations and actions while others will not tolerate a single action being open for more than a few months. The internal audit function might be working in both, but their effectiveness is determined by the culture.

I think auditing the risk and control culture of a business is absolutely fundamental for an internal audit department, to provide an independent assessment of how well that culture is embedded across an organisation.

It may be particularly important for the non-execs who are increasingly reliant on internal audit to flag up any concerns. Particularly as it is possible for all the other boxes regarding controls to be ticked, but for the whole structure to be undermined by the prevailing culture.

Assessing culture can be challenging, due to its somewhat nebulous nature, but that's not a valid reason for internal audit teams to exclude it from their work.

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While it can be appealing to assess culture continuously within other audit work, I believe that on a regular basis there needs to be a large-scale all-encompassing culture audit to identify pervasive issues and themes.

In terms of what and how to audit culture, I think there are a series of hard controls that would be relatively straightforward to audit; such as, is there an ethical policy, or do they have a set of values and are they communicated down to people and built into their goals? All of these would generate a simple yes/no response.

In addition, through softer mechanisms such as workshops or questionnaires you can gain qualitative feedback - encouraging people, with guaranteed anonymity, to say what actually happens on the ground. All of this feedback can be combined to provide an overall view on culture and whether it supports a strong risk and control agenda.

It can be difficult for internal audit teams to be completely objective about culture when they are themselves embedded within it. While issues might stand out within the first few days or months in a new environment, after a period of time we're all susceptible to accepting things. You don't want your internal audit team not raising something because 'that's just the way it works around here.'

Also, to gain maximum insight from a culture audit, there needs to be absolute trust that any examples of 'bad behaviour' are not shared more widely in the organisation. This trust is usually easier to establish with a third party than an in-house team who have relationships across the business and with senior stakeholders.

For both these reasons, it's really important that there's external support for internal audit teams in order to provide a fresh perspective in their cultural audit.

Our specialists don't necessarily agree about the best way to take the cultural temperature of an organisation. Helen Charley has made a clear call for a single all-encompassing cultural audit as the best means to establish cultural themes. Katie Clinton argues for culture to be part of every audit, in order to build up an overall picture. KPMG Audit Partner, Bavan Nathan, puts forward his ideas on the best way to approach an assessment of culture.



Bavan Nathan

“ I believe leadership should empower their internal auditors to share their findings openly without fear of recriminations. ”

Auditing culture should be about detecting behaviours that are already within the business. Behaviours that affect it positively need to be encouraged and vice versa. I believe the best way to do that isn't as a one-off cultural audit, but as a collection of insights compiled from regular audits.

The beauty of this approach is that you don't have to look for culture, it'll jump out at you. In the past, auditors have stopped short of sharing their insights because they're used to reporting facts. They are trained into being risk averse, and fear upsetting clients by passing on perceptions which can't be backed up by hard evidence.

I believe leadership should empower their internal auditors to share their findings openly without fear of recriminations. It is in their interest to find out about staff mood, attitudes to head office, rules and regulations. It is only by identifying cultural elements that support the business and encouraging them that they can build up a positive culture.



Culture underpins every aspect of an organisation. It is something that needs to be examined at the macro rather than the micro level. Who would read a treatise on the correct way to behave in every possible situation? Having the correct culture, as Bavan suggests, empowers your people to behave in a way that supports your business objectives.

The financial services sector has had more experience than almost any other sector in auditing culture because of the increased regulation that they have faced over recent years. Helen Brennan, a KPMG Audit Director, agrees that cultural auditing is essential for banks and financial services providers. She uses her in-house perspective to take a closer look at the positive reasons to audit culture and why the smartest institutions are already doing it.





Helen Brennan

“ If you want to change culture, you have to start right at the top and ask whether the leadership is sufficiently diverse. This requires a radical DNA change with serious consequences for those leaders who lack the self-awareness and flexibility to make that change. ”

Culture has come under the spotlight recently because of changes made by the regulatory authorities. Banks already do a lot for the regulator to prove that they've got the right culture to benefit their customers, so yes, absolutely they need to audit for it. However, if that is the only reason they're focussed on culture, then I think they're missing a trick.

Banks should want to have a strong coherent culture for performance reasons, because research shows that organisations with strong culture, aligned to values, outperform the market. This is intuitive, in that strategies are more likely to be realised by highly motivated employees sharing common goals; but it's also borne out in customer experience.

When you look at the decision makers in many established banks, they're mostly men in their 40s and 50s who have grown up in a different culture than the one we now aspire to. It's embedded in their identity which drives their beliefs, influences the skills they have acquired, how they behave and the culture they lead. If you want to change culture, you have to start right at the top and ask whether the leadership is sufficiently diverse. This requires a radical DNA change with serious consequences for those leaders who lack the self-awareness and flexibility to make that change.

You might see new entrants to the banking arena as having an advantage in that they don't have to deal with the legacy issues of embedded behaviour which can affect the more established banks. I would say that it's not a question of how long a culture has been in place – it's about how fundamentally that culture is a part of the identity of the organisation and its leaders.

Strong culture manifests itself in moments of truth, those situations where there's a trade-off between two priorities, for example a profit for the bank or a lower fee for the customer. These should be relatively straightforward to identify: externally they're moments where the bank's service makes a key difference to the customer; internally it's where the fault line lies between declared values and incentivised behaviour.

Humans are creatures of habit. If I've behaved in a particular way 20 times, it's likely that on the 21st time faced by the same set of circumstances I will do the same - particularly if under stress – regardless of whether a new list of values have been stuck to the wall.

In my view, that's why banks' existing behavioural statements were largely ignored in the past. The rainmakers (the individuals who made big profits) learned over time that their ability to bring in money meant that transgressions on their part would be overlooked.

Changing that pattern means less reward for the short-term profit the bank gains by their presence, and greater sanction for the long-term negative impact on reputation and performance their bad behaviour causes. You can still applaud wins but you have to call out bad behaviour, rather than dealing with it quietly behind the scenes.

It's not just the badly behaved rainmaker who needs to change but also anyone blocking diversity in the recruitment process. People tend to recruit in their own image, but identikit recruiting will lead to identical problems.

So to bring it back to audit. Yes, I believe there is a need to assess the impact of culture, but the vision needs to go from top to bottom, from the fundamental identity of leaders to frontline customer service. It's not possible to audit culture itself, only proxies of it. The results need to be seen in the context of the big picture, rather than straightforward “yes”/“no” responses that could lead to more of the perverse incentives many organisations are trying to get rid of.

Internal audit of culture is most valuable when the findings are related to the entire organisation, from aspects of identity at the very top, to daily transactions at the bottom. The real value comes from enabling leaders to develop strategy that integrates what they want to achieve with the more fundamental question of who they want to be.

All our audit specialists agree that culture should absolutely be a part of internal audit's scope. Having a strong, positive culture is crucially important, not just to support the risk control framework, but also to maximise opportunities, as Helen has explained. While there is some disagreement about the best model of a cultural audit, all of our experts are clear about the need to support internal auditors in carrying out this task effectively. This further underlines the need for effective guidance from the CIIA about the best way to go about measuring culture in organisations.

The second area of focus for our cultural audit specialists was whether or not there were any absolute indicators of good and bad culture and what they were. David Fineberg, Audit Director in FS Banking, argues that there are. Here is his view of the cultural indicators that auditors should be looking for.



David Fineberg

“ A company with good culture demonstrates that they take conduct risk and culture seriously... it's about holding their hands up when they've done something wrong. ”

Transparency is the most important factor, underpinning the various indicators of good and bad culture for internal audit to consider, when reviewing the overall culture of an organisation. Workplaces characterised by open and honest behaviour are a world away from organisations blighted by a culture of opaque and dishonest activity.

A first indicator of a good culture is a strong governance structure – evidence that managers effectively supervise the activities and behaviour of their staff. In addition, individuals need to have their responsibilities clearly defined for there to be a 'good' governance structure. Every organisation should have a clear structure of who reports to who with clear awareness of what the responsibilities are of each individual within that structure.

A transparent structure such as this allows for effective monitoring of risk. If there are any incidents where the risk appetite is breached or exceeded, it is more likely to be quickly identified and appropriate action taken.

A bad culture would be typified by a lack of control or an opaque structure where it's unclear who reports to whom. For example, if a trader is insider dealing and it's not clear who is monitoring them, this inappropriate activity may well go undetected.

A second indicator of good or bad culture would be the reaction of an organisation to incidences of wrongdoing. Incidents like this aren't in themselves indicators of bad culture. In the past few years there have been several incidents when banks

have suffered 'rogue trader' losses. Certain banks have been proactive in their reactions to such incidents, disciplining the individuals concerned and putting in measures to prevent similar incidents happening in the future. This openness can be an example of a good culture.

Bad culture would be to go on the defensive and try to cover up mistakes, rather than acknowledging liability. In other words, not being open about things that went wrong.

Thirdly, internal auditors should examine the level of transparency around how organisations treat their customers. A company with good culture demonstrates that they take conduct risk and culture seriously. Once again, it's about holding their hands up when they've done something wrong.

The PPI mis-selling scandal was an indication of widespread bad culture amongst banks and other financial institutions. They mis-sold insurance to customers and refused to fully compensate customers until ultimately forced to by a High Court ruling.

Interestingly, the British Bankers Association (BBA) showed good culture by accepting the ruling without appeal.

This is a great example of how you can see cultural indicators shifting. Although banks have been forced into compensating their customers, the BBA's decision not to appeal showed a commitment to put customers before profit.

David Fineberg argues for universal cultural indicators based around transparency and good governance in his article. Once again, not all our audit specialists agree here. It might seem counter-intuitive to argue against transparency and good governance, but Bavan Nathan feels that culture is much less homogenous than David's approach would suggest. Bavan presents the case for auditors to be sensitive to the nuances of their environment, something which could take the profession away from traditional thinking. Auditing culture may well be more complex than a straightforward pass or fail.



Bavan Nathan

““ Businesses can attempt to define their desired culture through values, but I believe this gives a very narrow focus. Any audit against values risks becoming a tick-box exercise. It doesn't get to the root of why staff comply or not. ””

As internal auditors we have a natural inclination to measure against statistics, rules and protocols but this approach does not work when measuring culture. Culture is intangible: it shifts within and between organisations, departments, teams and individuals. Attempting to codify culture with a series of structures and processes risks missing the point entirely.

Any top-down approach instantly narrows the focus of an audit, because you have to decide what you are measuring, sample results and drill down into the detail. While this is a great way to tackle a specific issue, you can lose the broad perspective that you require when looking at culture.

Businesses can attempt to define their desired culture through values, but I believe this gives a very narrow focus. Any audit against values risks becoming a tick-box exercise. It doesn't get to the root of why staff comply or not.

Everyone can clearly experience differences in culture. Two airlines for example can feel very different. This is cultural, but it's really hard to pin down exactly how or why. There are no specific indicators that can be universally applied, each organisation is unique.

Many failures with internal controls are to do with people error, individuals circumventing controls. As auditors traditionally we have concluded there is a problem with the controls, whereas actually the problem may well be with the underlying culture; in other words, what is motivating those individuals to circumvent the controls?

Widely publicised failures in financial services such as fraud, mis-selling or ineptness, are at their core all concerned with culture. I'm convinced that the more cultural feedback is analysed, the more we will see the connection between culture and problem areas.

Auditors need to have the courage of their convictions when feeding back on culture. They are in a unique position being both within and outside businesses, which allows them the distance required to analyse their findings. By maintaining an awareness of culture while undertaking their regular audits, they can really support a business to achieve its objectives.



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