

TONE at the TOP

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EXCLUSIVELY FOR SENIOR MANAGEMENT, BOARDS OF DIRECTORS, AND AUDIT COMMITTEES

Soft and Strong: A Best-practice Paradox

How often have you heard of organizations referred to in such terms as:

- Having a pervasively toxic and dysfunctional atmosphere?
- Depicting a mentality of “do as I say, not as I do?”
- Following a tone at the top that talks the talk, but does not walk the walk?
- Demonstrating an entitywide “cover yourself” mindset?

If you are like many in today’s business environment, just reading these descriptions will make your shoulders tighten and your stomach churn! But we’re not talking hypothetically... Countless executive leaders, boards of directors, and audit committees ignore what has become a broken and pervasively negative culture in their organizations — so much so that it’s actually “business as usual” in their world.

It’s interesting that internal controls related to these types of settings are labeled “soft.” Actually, there’s nothing soft about either working under, or trying to improve, such circumstances. This is hard stuff — very hard.

Even in companies where executive management models the highest ethics, business units may create their own

subculture that sometimes can be contradictory to the tone set by those at the very top. This magnifies the importance and complexity of assessing soft controls to determine whether there might be gaps between stated and actual corporate values at any level that would signify specific weaknesses in the corporate culture.

The corporate culture is the most powerful control in any organization.

- Jim Roth, author

Best Practices: Evaluating the Corporate Culture

Unlike cut-and-dry, clearly defined controls, soft controls are extremely subjective and intangible. And auditing them is neither simple, nor black and white; neither prescriptive, nor predictable. In other words, one size does NOT fit all. Yet, corporate failures of the past and best practices point to the need for assessing the integrity of an organization’s soft controls. It’s essential to providing management and the board assurance that the organization will not join the ranks of those that have been brought to their knees by lagging ethics and a weak corporate culture.

EXAMPLES OF SOFT CONTROLS

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|--------------------------|-----------------------|
| ▪ Tone at the top | ▪ Corporate attitudes |
| ▪ Morale | ▪ Openness |
| ▪ Competence | ▪ Shared values |
| ▪ Ethical climate | ▪ Leadership |
| ▪ Operational philosophy | ▪ Expectations |
| ▪ Empowerment | ▪ Employee motivation |
| ▪ Trust | ▪ Integrity |

A FRAMEWORK FOR CONTROL

Obtaining reliable information about soft controls is one of the most difficult challenges internal auditors must confront, and it can be quite daunting. The Institute of Internal Auditors (IIA) Research Foundation recently released *Best Practices: Evaluating the Corporate Culture*, by James (Jim) Roth, PhD, CIA, CCSA. This research report delves into creative and innovative practices implemented by exemplary organizations to ensure soft controls are working effectively.

Using the Committee of Sponsoring Organizations of the Treadway Commission's *Internal Control — Integrated Framework* components, the study categorizes soft controls under each of the following:

- Control Environment
- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring

According to the study, examples of soft controls in the control environment that should be assessed include such things as integrity and ethical values, commitment to competence, and the structure of reporting relationships and information flow. Also critical is the extent to which the board of directors or audit committee is involved with and understands the organization; as is management's philosophy on leading by example and fostering an atmosphere of mutual trust.

GUIDELINES FOR EVALUATING THE CORPORATE CULTURE

Tools highlighted in the study include surveys conducted during audit projects, participative and risk-based audits, entity-level interviews, entitywide surveys, and soft control reports.

Surveys should use statements or questions in simple lay language that asks for a level of agreement or disagreement on a scale. They should be field tested to ensure clarity and optimal value. After assuring confidentiality, participants should be asked to explain any negative responses, and perceptions should be validated for accuracy.

WORST PRACTICE EXAMPLE

Enron's failure in 2001 kicked off a wave of public scandals and led to the U.S. Sarbanes-Oxley Act of 2002 and similar regulations in other countries. This company's formal governance structure was seemingly strong, but the informal communications and behavior of management created a culture that was almost diametrically opposed to its stated values. An internal audit department that had focused on evaluating soft controls might very well have identified the gaps between the stated corporate values and the values that were practiced in reality.

SOURCE: *Best Practices: Evaluating the Corporate Culture* by Jim Roth. (Available from the IIA Research Foundation at www.theiia.org/bookstore)

The participative, risk-based audit approach includes collaboration between the internal auditor and management to delineate business objectives, risks, and likelihood and impact of each risk. It also includes the participation of, and alignment with, various levels of the organization. Focusing on the design of the controls and investigating the cause of the findings will uncover weaknesses in the system. Finally, the internal auditors should be experienced, have good interpersonal skills, and be able to tailor the approach to the style of the manager.

When conducting entity-level interviews, the guidelines mirror those delineated above for audit project interviews, plus asking questions that force people to think, reading body language and tone of voice, and asking for concrete examples. The

FIVE PRINCIPLES FOR EVALUATING SOFT CONTROLS

1. Ask "constructively challenging" questions of management and "confirming" questions of employees.
2. Identify and obtain management's agreement on the criteria for evaluation and what will constitute legitimate audit evidence.
3. Get "hard" evidence about the results of the soft control when possible.
4. Focus on the underlying management process.
5. Develop and report results in partnership with those accountable. Use appropriate (perhaps informal) means of reporting.

SOURCE: *Jim Roth's seminar, "Five Principles for Evaluating Soft Controls."*

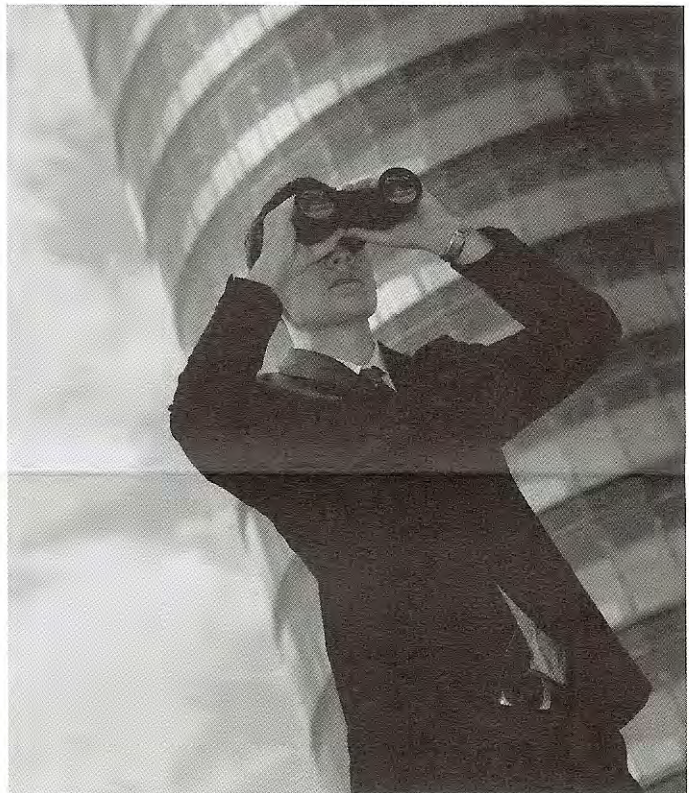
participative, risk-based audit project guidelines also apply to entitywide soft control surveys. These surveys require proactive support from the top. They will also serve as an upward or peer evaluation. However, confidentiality must be balanced with the ability to follow up on the issues, and the number of issues addressed must be balanced with the length of the survey. Sometimes an existing survey can be updated and enhanced to serve as an effective entitywide survey.

When reporting on soft controls, some audit departments only provide verbal reports. However, formal reports are preferable as long as they can be delivered without creating an adversarial relationship with the managers who are audited. In order for it to work, the organizational culture must support the process and buy into the value of formal reporting. In such environments, the audit process is regarded as a path to improvement — an opportunity for good managers to grow into great managers.

Because soft controls are highly subjective, evaluating them objectively can be quite a challenge. The internal auditors must provide persuasive evidence indicating soft control weaknesses. If such evidence cannot be obtained, internal auditors should express their perception to the responsible manager, allowing that individual to fix the situation without involving higher levels of management. And certainly, all comments in the audit reports should be phrased very carefully and should provide a full perspective.

MEET THE AUTHOR

Jim Roth, the author of the research, emphasizes that those at the top should pay particular attention to the culture that exists within their organizations. “The corporate culture is the most powerful control in any organization,” says Roth. “The root cause of every major control breakdown — Enron, WorldCom, Tyco, etc. is a weakness in the culture. More than anything else, stakeholders need assurance that the ‘soft controls’ that create and embody the corporate culture are sound.”



A VIEW OF VALUE FROM THE TOP

The 19 successful organizations cited in this research report said that their upper management and audit committees value soft control auditing more than traditional audit work. This should speak volumes to those at the top of organizations everywhere — especially those who might think of “soft” as being synonymous with “unimportant” or “unnecessary.” And if they are not convinced of best practices by this study, perhaps they have already forgotten the lessons the corporate world and its stakeholders learned from practices exhibited at the opposite end of the spectrum.

PLEASE TAKE OUR READERS SURVEY!

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Mission

To provide executive management, boards of directors, and audit committees with concise, leading-edge information on such issues as ethics, internal control, governance, and the changing role of internal auditing; and guidance relative to their roles in, and

responsibilities for, the internal audit activity.

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