Sustaining an Ethical Culture

A strong ethical culture, including clear expectations for acceptable conduct within the organization and with third parties, is essential for good governance. Ethical behavior, however, involves much more than a code of ethics. The audit committee plays a critical role in ensuring that an organization's culture aligns with its code of conduct, that behaviors are consistent from top to bottom, and that corporate values resonate throughout the organization. But getting a true understanding of an organization's ethical culture can be difficult when the people the audit committee relies on most for information about the organization — senior management — are the people who, ultimately, must be held most accountable.

According to KPMG's 2014 Global Audit Committee Survey, nearly 90 percent of audit committees get a sense of the company's tone and ethical culture by having frequent, informal communications with the CEO, CFO, and other senior executives. Only 45 percent interact with employees below the C-suite, and 26 percent conduct employee surveys. Indeed, overreliance on senior management's perspective can create unintended risk.

In this issue of *Tone at the Top*, seasoned professionals offer five tips to help audit committees reduce that risk and boost the organization's ethical culture.

1 Set clear expectations

"The audit committee should have a governance framework," says John Lewis, chief audit executive (CAE) at Safeway Inc., a food and drug retailer named on Ethisphere Institute's annual list of the world's most ethical companies. Safeway's governance framework resembles a pyramid, with line management at the bottom, the board of directors and executive management in the middle, and shareholders at the top. The Safeway governance model is bound by the governing forces of transparency and communication, measurement and accountability, and internal and external audit.

According to Lewis, Safeway approaches ethical risk as it would any risk. "Within that framework, you

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would want to make sure that you have communication mechanisms in place — fraud reporting thresholds and a whistleblower hotline," says Lewis. Anti-bribery and corruption, gambling, customer privacy, competitive intelligence, and money laundering are all components that should be addressed, he says.

Lewis recommends having internal audit conduct an extensive review of best practices to find out what should be considered in a corporate governance framework, which policies and procedures have been in place, and how the risk management program should be implemented.

Internal audit may provide valuable input by making recommendations in the development of a corporate governance framework based on best practices. Internal audit also may identify formal policies and procedures that should be in place to support the program, and advise on the implementation of the risk management program.

2 Check tone in the middle

Peter Gleason, managing director and CFO for the National Association of Corporate Directors, encourages audit committees to reach beyond the C-suite by engaging middle managers and reviewing employee surveys and whistleblower reports. By looking for patterns and anomalies, audit committees may be able to identify areas of the company that warrant closer audit attention.

"You could start looking at statistics, like employee turnover rates," he advises. "If you have a large number of middle managers exiting on a regular basis, then you may have an issue in the level above them where they aren't allowing people to progress."

Talking to managers and employees throughout the organization can give audit committee members a more holistic understanding of the organization, its operations, and its people. In many cases, it's the employee's direct manager who sets the tone.

Employees follow their manager's lead. For this reason, the middle is a good place to look for signs of tears in the organization's ethical fabric.

3 Make ethics a priority

Senior executives must make ethical behavior and tone at the top a priority. It is about both "talking the talk" and "walking the walk." Employees notice even subtle differences between tone and actions. And, according to the Ethics Resource Center, fear of retaliation is the No. 1 reason why issues aren't raised by employees. Beyond simply establishing an independently monitored, anonymous hotline, senior executives must consistently promote a work environment with an open-door policy, where employees feel safe raising questions and concerns.

Audit committees are in a unique position to influence the ethical tone set by senior management and can do so by modeling ethical behaviors themselves. A strong ethical culture emanating from the board and the audit committee, with accountability resting with the CEO and senior executives, will serve to establish the right tone at the top. Integrity at the top encourages and supports a strong tone in the middle, which, in turn, promotes a robust and sincere ethical culture.

"Audit committees should have a list of questions they want answered and things they're looking for," says Bruce Sloan, senior principal of the Canada Office of the Auditor General. "Does the organization have formal ethics and values policies? Does it have a champion for ethics? Are employees regularly trained on ethics? Are people talking about values and ethics on a regular basis? These things are proxies for a healthy ethical culture."

4 Enforce and incentivize the code

Fair is fair. The code of conduct must apply and be enforced at all levels of an organization. There can be no exceptions. Anything that resembles special

treatment can undermine employee morale and serve as justification for other exceptions. Once breached, employee trust can be difficult to re-establish.

"As an ethics officer, I was often disappointed in the actions of executives," recalls Catherine Henry, a former ombudsman and ethics and compliance professional. "They walk the talk when things are running smoothly, but frequently lack the courage to do the right thing when they have a personal stake in the outcome."

When it comes to promoting ethics and integrity, it doesn't have to be punitive. By incentivizing ethics and making the promotion and emulation of company values a key performance indicator, companies can elevate their ethics and compliance initiatives from burden to brand standard. For example, in top organizations, company leaders highlight situations in which an individual's integrity is a shining example of the company's core values.

5 Look to internal audit

According to the Ethics Resource Center's 2014 National Business Ethics Survey, "A strong majority of misconduct is attributable to individuals who hold some level of management responsibility." Moreover, nearly a quarter of misconduct is committed by *senior* management.

Audit committees should look to their independent internal audit functions to provide additional eyes and ears trained to evaluate and objectively report on the organization's ethical culture. Indeed, internal audit can play a key role in assessing the design, implementation, and effectiveness of ethics-related objectives, programs, and activities. The audit charter, coupled with internal audit's native familiarity with the day-to-day workings of the organization, make internal auditors especially valuable to audit committees seeking a more robust and well-rounded assessment of the ethical culture.

Investing in Ethics

By making ethics and compliance a priority, looking beyond the C-suite to check the tone in the middle, leading by example, and using internal audit resources effectively, audit committee members can get a better sense of the ethical climate at the companies they oversee. Because tone at the top, a strong ethical culture, and values that support both are fundamental to an effective risk and control environment, a little extra effort in this regard will suit boards and audit committees well over the long term.

Questions Audit Committees Should Ask

- Are we gathering information from all levels of the organization?

- When was the last time we got an assessment of our whistleblower hotline and associated policies and procedures?

- Does the internal audit plan include a review of company culture and ethical risks?

- Does the organization have a formal ethics policy, and are employees properly trained?

- Have we asked the CAE to share his or her views on ethics, culture, and values of the company?

Quick Poll Question

Does your organization provide training on how to make ethical decisions?

Visit **www.theiia.org/goto/quickpoll** to answer the question and see how others are responding.

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Quick Poll Results:

How confident are you that your organization's third-party risks are being addressed adequately?

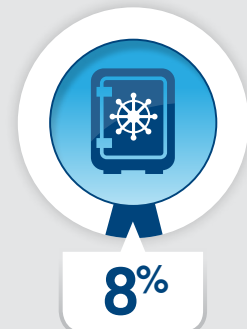| LITTLE-TO-NO CONFIDENCE	SOMEWHAT CONFIDENT	VERY CONFIDENT
39%	53%	8%

*Based on 574 responses. Respondents could only choose a single response.