Internal Audit’s Role in Reviewing Governance

Essay Topic:
Assessing Governance – internal audit’s role in reviewing the top of the organization

1. What happens when the structure or practices of governance are the problem?
2. What ruler should internal audit be using to “assess” and “advise” governance, and can internal audit overstep its role?
3. How does internal audit manage the delicate political balance in proposing, participating in, and reporting on a governance assessment where they are effectively reviewing their boss?

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Submitted by:
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About the Author

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Introduction

The global financial crisis and collapse of many large companies around the world highlighted fundamental issues around organizational governance. Since then, we have seen more stringent regulation and increased expectations of internal audit from its stakeholders. Reviewing and assessing governance is an important element of internal audit’s work, but it also involves a delicate balance between managing effective stakeholder relationships and independence. Findings from the latest Institute of Internal Auditors (IIA) Common Body of Knowledge (CBOK) study showed that about 27% of internal audit conducts extensive reviews of organizational governance.

This essay begins by defining ‘governance’ and providing examples of what can go wrong when there are issues with the structure or practices of governance. It then explores some well-known governance frameworks and other tools internal audit can use to assess and advise on governance; noting that ‘culture’ is a key element of governance and can be difficult to assess and report on. Whether internal audit can ‘overstep’ its role can be interpreted in different ways; but to answer this the essay explores the mission of internal audit, cases where internal audit has ‘blown the whistle’ on management and how assessing behavior can be subjective. Related to the concept of ‘overstepping,’ the final part of the essay investigates the ‘delicacy’ of internal audit reviewing governance within its own organization and suggests ideas of how internal audit manage this.
**Understanding Governance**

To begin, we need to understand what we mean by the term ‘governance.’ As governance is such a broad concept, there is no single, universally accepted definition. The Institute of Internal Auditor’s define governance as “the combination of processes and structures implemented by the board to inform, direct, manage and monitor the activities of the organization toward the achievement of its objectives.” The definition from the Australian Securities Exchange’s Corporate Governance Council is similar: “the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled within corporations. It encompasses the mechanisms by which companies, and those in control, are held to account.” Although there are many definitions, governance is all about how an organization sets its purpose, strategy, culture, values, and how it communicates and engages with its stakeholders.

Some traditional definitions of governance (such as the Financial Reporting Council’s UK Corporate Governance Code definition) focus on ‘shareholders’ as the key stakeholders of an organization, but it could be argued that organizations are increasingly accountable to a much wider group of stakeholders. The momentum of ‘Corporate Social Responsibility’ means that organizations are held to account by stakeholders globally, nationally and locally. The 2018 Edelman Trust Barometer report showed that there is a feeling that “CEOs should take the lead on change rather than waiting for the government to impose it.”

Each organization should define governance in the context of its own organization, and internal audit may need to work with the board and executive management to determine how governance should be defined for audit purposes. What is said to be ‘good governance’ may vary across different organizations, depending on their industry, size, regulatory environment, maturity, and extent of globalization.

**Why is Governance Important?**

Good governance is important for all organizations; public and private companies, joint ventures and partnerships, government entities, not-for-profit organizations, regulatory bodies, academic institutions, and community organizations. It’s essential for achieving organizational objectives, driving improvement, and maintaining legal and ethical standing in the eyes of stakeholders.

The governance of publicly traded companies has a direct impact on capital markets and is important for investor protection. For stability in the banking sector, good governance of financial institutions is crucial. In emerging market counties and ‘start-up’ organizations, good governance can improve performance and lower their cost of capital, as it may open doors to more affordable external financing. As millions of households around the world have their savings in the stock market, either directly or indirectly, governance has an important role to play in the achievement of broader economic objectives.
Structure or Practices of Governance

A governance structure consists of an organization’s design, reporting structure and relationships between its governing bodies. Different organizations may call their main governing body a board of directors, council, court, committee, or just the ‘governing body’. From a risk context, the relationship between various governance groups or functions can be demonstrated using the ‘Three Lines of Defence’ model:

![Figure 1: Three Lines of Defence Model](source)

Governance practices are how the governing bodies make decisions, inform, direct, manage and monitor an organization. This also includes elements of ‘culture’ (the sum of an organization’s shared values, principles and behaviors) and ‘corporate social responsibility’, which can be described as “the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as the local community and society at large”.

What Happens when the Structure or Practices of Governance are the Problem?

Many governance issues arose from the global financial crisis after governments had to ‘bail-out’ large corporations. Inadequate or ineffective governance structures in some organizational failures was evident from: the lack of board committees or where a committee consisted of a few or a single member, non-independent board and audit committee members; or a Chief Executive Officer fulfilling multiple roles in various committees.

Governance is far more than a prescribed ‘structure’, and many organizational losses or collapses are not only failures of legal compliance but are more fundamentally failures to do the right (ethical) thing. Research shows that people look to cues from the behavior of those around them to determine how to behave and interact. In the wake of Volkswagen’s ‘emissions scandal’, where a defeat device was used to cheat emissions tests, it’s been proven that Volkswagen intentionally made false and fraudulent statements about the ‘irregularities’. When news broke about BP’s Deepwater Horizon oil spill in the Gulf of Mexico, the Chief Executive Officer famously referred to the spill as ‘tiny’ and remarked ‘I
want my life back\textsuperscript{14}. These are both examples where organizations have failed to do the ‘right’ thing and both companies share prices significantly dropped because of these incidents.

Other common failures of governance include: management circumventing internal controls and making misrepresentations to auditors and the board; having inappropriately qualified members holding board positions or audit committee members who don’t have appropriate accounting qualifications or experience to analyze key business transactions. The famous collapse of Enron and its auditor (Arthur Andersen) show that bad governance activity can occur despite having the appropriate structures in place. This classic case shows evidence of Board shortcomings, ignorance by the auditors, regulators, analysts and a corporate ethical culture that should have raised red flags\textsuperscript{15}.

Where there are failures in either governance structures or processes, organizations are susceptible to significant losses, damage to reputation or even failure. Important lessons can be learnt from failures of governance and it’s important that internal auditor’s review and understand these so potential red flags can be picked up as part of their own reviews.

**Assessing Governance**

**Internal Audit’s Role in Reviewing Governance**

The role of internal audit (from the Definition of Internal Auditing) includes the responsibility to ‘evaluate and improve’ the effectiveness of governance processes\textsuperscript{16}. In line with this definition, an organization’s internal audit charter should state that the scope of work includes all governance activities and processes\textsuperscript{17}. The audit committee and internal audit need to decide what the audit approach should be for assessing and contributing to the improvement of governance. Different audit approaches will depend on the maturity of the organization, the complexity of the organizational structure, existing audit types; and the size of the internal audit team\textsuperscript{18}. The IIA’s International Professional Practice Framework (IPPF) Standard 2110 outlines that internal audit must assess and make appropriate recommendations to improve the organization’s governance processes for:

- Making strategic and operational decisions.
- Overseeing risk management and control.
- Promoting appropriate ethics and values within the organization.
- Ensuring effective organizational performance management and accountability.
- Communicating risk and control information to appropriate areas of the organization.
- Coordinating the activities of, and communicating information among, the board, external and internal auditors, other assurance providers, and management.

Internal audit can perform a review governance in either an assurance or consulting/advisory capacity, so it’s crucial that there are clear objectives and a clearly defined scope for reviews. An assurance review could assess compliance with external governance standards or codes or assess against internal standards and expectations of good governance. In a consulting/advisory role, internal auditors are increasingly performing ‘culture’ reviews and ‘deep dives’ into specific areas of governance\textsuperscript{19}.
Internal audit can integrate governance elements into every audit, or conduct ‘thematic’ reviews of an entire framework within the organization. When planning reviews of governance, internal audit should also consider whether there have been previous issues of governance or culture, or whether the work of other assurance providers (or regulators) is relevant (for example: a compliance function or external audit’s review of governance statements in the annual report).

**Tools to Assess Governance**

The resources and guidance an internal auditor would use for a governance review will depend on the audit approach, scope of the review and nature of the organization. All countries have their own unique systems of corporate governance; reflecting different various economic, cultural and legal circumstances. Given the international nature of business, it’s helpful for internal auditors to have an awareness of global governance standards and frameworks. Even if a framework or code isn’t binding for an organization, it can be a useful tool for internal audit to compare their organization and use as a basis to make appropriate recommendations.

The Organization for Economic Co-operation and Development (OECD)’s *Principles of Corporate Governance* are built on the expertise and experience of policy makers, regulators, business and other stakeholders from around the world. These principles provide a globally recognized benchmark for assessing and improving corporate governance. The Financial Reporting Council’s *UK Code of Corporate Governance*, which applies to listed UK companies, contains broad principles and specific provisions which set standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders. The Australian Securities Exchange (ASX) Corporate Governance Council’s *Corporate Governance Principles and Recommendations* set out recommended corporate governance practices for entities listed on the ASX. While not mandatory, the framework uses the ‘if not, why not’ approach where entities must explain why they have not adopted a recommendation. This means that reviewing the annual reports of listed companies may also be useful for internal audit to assessing whether a principle is ‘fit for purpose’ for an organization or industry.

In the United States, the Securities and Exchange Commission (SEC) and listing rules of stock exchanges play a significant role in the governance of listed companies. There is no code of corporate governance in the United States due to the federal nature of its constitution. The Sarbanes-Oxley Act (introduced in 2002 following the collapses of Enron and others) also has requirements of corporate governance for entities listed in the United States.

The Global Institute of Internal Auditor’s resources such as the *Practice Guide’s on assessing governance in the private sector* (2012) and *public sector* (2014) and Common Body of Knowledge (CBOK) report on *Promoting and Supporting Effective Organizational Governance – Internal Audit’s Role* are also excellent resources to use when planning a review of governance. Depending on the type and scope of governance review, other frameworks such as the Committee of Sponsoring Organizations of the Treadway Commission (COSO) Internal Control Framework may also be useful (for example if assessing risk management processes).
If Corporate Social Responsibility (CSR) elements are in scope, a comparison against a CSR maturity model or sustainability reports from publicly listed companies may be useful. The Institute of Internal Auditor’s has also published a practice guide on *Evaluating Corporate Social Responsibility/Sustainable Development*. A listing of the frameworks and tools mentioned above is provided in Appendix 1. Elements of a governance ‘framework’ review that internal audit could assess (against the requirements of IPPF 2110) are outlined in Appendix 2. In order to assess the design, implementation, and effectiveness of governance processes; internal audit needs to use a range of testing approaches and audit techniques to delve deep into the *effectiveness* of processes and controls. The power of observation should not be underestimated, as it’s important to get an understanding of relationship dynamics and extent of debate. For example, to assess whether key decisions are made after appropriate discussion and everyone has a chance to have their say; it may be more effective for internal audit to sit in on a board meeting rather than review board minutes and other documentation.

**‘Culture’ Elements of a Governance Review**

Structural and process elements of governance might be easy to audit, but as governance is also about an organization’s ‘culture’ and people’s behaviors, internal audit needs to consider how it will assess ‘soft’ controls such as trust and openness, leadership, values, ethical standards. An organization’s internal resources such as employee engagement surveys, code of conduct and ‘exit’ interviews might also be useful ‘rulers’ to consider when assessing and advising on ‘culture’ elements of governance. Being able to track metrics over time is a good way to evidence changes in values and behaviors.

A recent report from IIA-Australia and other Australian professional bodies on *Managing Culture — A Good Practice Guide* provides insight on the critical role internal audit plays in achieving better corporate culture. The Financial Reporting Council’s *Corporate Culture and the role of Boards* (July 2016) also provides useful definitions, key observations, questions for boards and other information on how to assess, measure and monitor culture. Models such as the ‘Cultural Web’ developed by Gerry Johnson and Kevan Scholes (Appendix 3) provide another approach for reviewing at and assessing an organization’s culture.

A wider group of stakeholders may be useful to consult when assessing and advising on governance, such as the external auditors (or other assurance providers). While internal audit is fully vested in an organization and might be able to recognize significant changes in culture, values, motives, strategy, etc., more gradual shifts are unlikely to be recognized. External auditors (or other assurance providers), who see the organization at certain intervals might be able to give insights on whether they see any shifts in culture or changes in governance practices.

**Can Internal Audit Overstep Its Role?**

The idea of internal audit ‘overstepping’ its role can be interpreted in many ways, for example:
Given the internal audit’s role and mission; can the profession ever be criticized for ‘overstepping’ its role?

Can internal audit go beyond their reporting line to report on issues? What if the audit committee or internal audit is one of the issues?

Given a large element of governance is all about people and behaviors, can reporting on this jeopardize internal audit’s stakeholder relationships?

How does internal audit manage its own conflict of interest when it is part of the governance framework itself?

### The Internal Audit Mission

The mission of internal audit is to “enhance and protect organizational value by providing risk-based and objective assurance, advice, and insight”\(^{21}\). ‘Advice and insight’ implies the need for internal audit to share all of its professional thoughts and considerations so that management can make the best possible decisions\(^{22}\). In the context of the mission, technically can internal audit ever really ‘overstep’ its role? In the context of a specific organization, perhaps internal audit feel that a governance review is required given the significant risks, but receive resistance from either the audit committee or the board, who might see it as ‘overstepping’ their role.

### Can Internal Audit go beyond its Reporting Line?

Internal Audit is accountable to the Audit Committee, who is accountable to the Board, who is charged with the ultimate responsibility of effectiveness of internal controls within organizations\(^ {23} \). If internal audit uncovers fraud, corruption or other wrongdoing, they can ‘blow the whistle’ to higher authorities speak out to regulators. An example of this was the classic WorldCom case, where an internal auditor uncovered and investigated the accounting fraud which bankrupted the organization.

### Challenging People’s Behavior

Governance processes are interwoven into the ‘culture’ of an organization, which is apparent from people’s actions and behaviors. When assessing this, who’s to say that a behavior is inappropriate or not? Differences in identity, cultural background and experiences mean that what some people view as inappropriate, others may view as completely ethical and appropriate. A great deal of care needs to be taken when discussing potential observations, as they may be sensitive and have a long-lasting impact on stakeholder relationships. Internal audit’s ‘overstepping’ its conflict of interest is discussed in the next section.

### The Conflicting Role of Internal Audit

Internal audit assessing governance involves a delicate ‘political balance’ as they are effectively reviewing their ‘boss’. Internal auditors are dependent on management for their livelihood, so they will naturally want to keep good relationships with management. If they accuse management doing the ‘wrong’ thing, they could feel as though they are unlikely to be appointed by management to other positions in the future. Traditionally internal audit hires professionally qualified accountants rather than qualified internal auditors (with
relevant certifications such as the IIA’s Certified Internal Auditor (CIA) qualification and often has secondment arrangements with other areas of an organization. If internal audit is seen as a ‘stepping stone’ to other areas of an organization, would they ever want to challenge management or cause a potential argument on governance processes?

**Independence and Objectivity**

As internal audit itself plays an important role in the governance framework of an organization, it needs to delicately balance ‘serving’ the organization while remaining independent and objective. Effective reporting lines need to be in place to allow internal audit to be independent of the Board and senior management (internal audit should report functionally to the audit committee). An organization’s internal audit charter should reflect the decisions regarding internal audit’s responsibility, authority, and expectations, as well as organizational placement and reporting lines. The IIA standards also recommend that the audit committee make decisions about appointing or dismissing a Chief Audit Executive.

A Chief Audit Executive should not have operational responsibilities beyond internal audit. If they do, these processes could themselves be subject to audit and raise independence concerns and impair objectivity. Similarly, if internal audit played an active role in implementing the organizations governance, risk management or controls, it will not be able to assess the effectiveness of management’s practices.

**Managing the Political Balance of Governance Assessments**

**Evolution of the Internal Audit Profession**

Over the last decade, the internal audit profession has been shifting towards more of a ‘modern’ approach. This is evident through the new mission of internal audit in 2015, where the consulting role of audit is emphasized through providing “Advice and insight.” Traditionally internal audit might have reviewed governance from more of a compliance approach by assessing the organization against standards and focusing on the structure of governance. As the profession evolves and promotes its reputation, management may become more open to the idea of internal audit consulting on areas such as ‘culture.’

**The Profile of Internal Audit within the Organization**

The treatment and regard for internal audit is crucial for effective reviews and recommendations on governance-related topics. Although there have been positive advances in the international standards and global profession, this may not have filtered into all organizations. There may still be "Jurassic Auditors" in organizations who focus on compliance and use outdated audit techniques.

A regular independent external quality assessment (as required by the IIA’s international standards) will address compliance with the international standards and identify opportunities to improve performance and benchmark against best practices. These assessments will also aid in raising the profile of internal audit and encourage more ‘modern’ audit practices including reviews of organizational governance and ‘culture.’
Skills & Competencies of the Audit team

Credible audit findings come from applying the required knowledge, skills, and experience (the Competency principle in the IPPF Code of Ethics). It’s crucial that audit staff involved in a review of governance have the right skills and experience. Reviews of governance or ‘culture’ are high profile and will involve meeting, assessing and challenging senior executives on their activities, practices, and behaviors. In addition to suitable ‘soft’ skills, team members will need to have a thorough understanding of the organization’s business strategy and culture. The Chief Audit Executive might consider whether anyone in the audit function has personal experience of being on a board or committee, which could help them better understand and assess governance. Similarly, if any auditors have undertaken specific leadership courses or have studied human behavior, this may also be useful in providing credible results and managing the delicate task of assessing management. If there are gaps in knowledge, skills or experience, the Chief Audit Executive should consider relevant training, guest auditors or a co-source arrangement to complete reviews of governance or ‘culture.’

How to Raise an Issue of Culture

As internal audit partners with management in many of its activities; formal, documented, risk-rated observations might not be appropriate where there are issues with ‘culture’ or behavior. In a dysfunctional environment, issues may need to be addressed at the top rather than through the normal process of auditing. An effective way to deliver the message of a ‘toxic culture’ might be to raise culture as a separate topic with the board or audit committee.

Using an External Assurance Provider

In cases where the political balance is especially difficult to navigate, it can be useful to engage an external firm to conduct the review. An external assurance provider might be in a better position to challenge management on their practices and could have experience from other organizations meaning they can benchmark an organization’s culture. Perhaps internal stakeholders (especially if they are junior) would also be more ‘open’ to someone who is external to the firm. Even if the observations and final messages are the same as what the in-house internal audit team would have raised, it can be argued that senior stakeholders might give more ‘weight’ to results from an external firm - and perhaps that’s worth paying for?

Conclusion

Good governance is essential for all organizations and has an important role to play in broader economic objectives. Examples where poor governance has led to failure, significant losses, or damage to reputation demonstrate the importance of good governance, including ethical leadership and a strong ‘culture’ in all organizations.

The role of internal audit in assessing and contributing to the improvement of governance will depend on the unique circumstances of an organization and a review can take either an ‘assurance’ or ‘consulting’ approach. There is no ‘perfect’ governance model as structures and practices need to be tailored to suit an organization, and what works for one organization might not be suitable for another. This makes assessing governance, particularly elements of
‘culture’, a challenging task. Internal audit can make use of well-known governance frameworks and other publicly available resources to assess and advise on governance. In addition, internal resources such as employee engagement surveys or ‘exit’ interviews might be useful. To make effective recommendations, internal audit needs to apply a good understanding of the organization’s strategy and objectives to determine whether governance processes are ‘fit for purpose.’ Auditors will also need to use ‘soft’ skills and audit techniques such as observation to assess the operating effectiveness of governance-related controls.

Internal audit needs to consider its own conflicts of interest to ensure independence isn’t compromised while assessing the governing bodies they report to. In order to navigate this political balance, internal audit must apply the international standards, have appropriate reporting lines, adequate skills, and experience, and occasionally address issues at the ‘top’ rather than the normal process of auditing. In some cases, it may be worth engaging an external firm to perform or assist with a review of governance.

The importance of internal audit’s role in assessing organizational governance is becoming increasingly recognized, and this will contribute value both through improved practices and recognizing early warning signs of governance issues.
Appendix 1 - Frameworks and Useful ‘Tools’ for a Governance Review

Examples of Governance Frameworks and Guidance:

- The Organization for Economic Co-operation and Development (OECD)’s Principles of Corporate Governance
- The Financial Reporting Council’s UK Code of Corporate Governance
- The Australian Securities Exchange (ASX) Corporate Governance Council’s Corporate Governance Principles and Recommendations
- Reports from publicly listed companies (governance statements in annual reports, sustainability reports, etc.)
- Listing Rules of stock exchanges
- Sarbanes-Oxley Act (United States)
- IIA Practice Guide’s on assessing governance in the private sector (2012) and public sector (2014)
- Common Body of Knowledge (CBOK) report on Promoting and Supporting Effective Organizational Governance – Internal Audit’s Role
- Committee of Sponsoring Organizations of the Treadway Commission (COSO) Internal Control Framework
- IIA Evaluating Corporate Social Responsibility/Sustainable Development.

Internal tools useful for assessing governance:

- Employee engagement surveys
- Code of conduct
- HR exit interviews
- Managing Culture – A Good Practice Guide’
- The Financial Reporting Council’s Corporate Culture and the role of Boards (July 2016)
- Cultural Web (Appendix 3)
- Other Assurance Providers
### Appendix 2 - Areas for Internal Audit to Assess

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<tr>
<th>Governance Process per IPPF 2110</th>
<th>Areas for Internal Audit to Review</th>
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| **Making strategic and operational decisions** | • Board composition/structure (including number of members, independence, diversity, skills and experience, knowledge of risk and the organization's industry)  
• Board charter/terms of reference, roles & responsibilities, processes and reporting  
• Training, recruitment & on-boarding process  
• Conflicts of interest  
• Frequency of and attendance at meetings (including length of time for discussion of key issues)  
• Recording of minutes/discussions (including level of discussion/debate/challenge of items)  
• Flexibility to allow for unexpected events  
• Time spent on decisions is appropriate to the level of risk involved  
• Rewards/ remuneration incentives |

| **Overseeing risk management and control** | • Risk appetite articulation  
• Contingency planning/crisis management  
• Information is timely, sufficient  
• Breaches/incident reporting  
• Emerging risks/ new legislation |

| **Promoting appropriate ethics and values within the organization** | • Executives leading by example  
• Code of conduct, Code of Ethics (how it translates values into guidance on acceptable behavior)  
• Disciplinary Procedures  
• Training/communication to ensure a shared understanding  
• ‘Culture’  
• Whistleblowing hotlines |

| **Ensuring effective organizational performance management and accountability** | • Controls for tracking, follow-up and completion of agreed Board actions  
• Delegations/cascading of responsibilities throughout the organization  
• Framework for setting/approving/communicating policies to align with the organization’s objectives  
• Clear approvals/ recommendations  
• Adequacy of information (KPI’s, information from all parts of the organization etc.) |

| **Communicating risk and control information to appropriate areas of the organization.** | • How decisions are communicated to the organization (are they clear and to all parts of the organization?)  
• Setting and communicating risk appetite  
• Understanding of risk management throughout the organizations |

| **Coordinating the activities of, and communicating information among, the board, external and internal auditors, other assurance providers, and management** | • Non-executive director meetings with assurance providers  
• Three lines of defence evolution  
• External Audit relationships |
Appendix 3 - The Cultural Web

Source: Johnson, Scholes & Whittington (2005)
References


