Deloitte.

May 2017

On the board's agenda

Would you recognize the warning signs of a toxic culture?

New reports continue to emerge about organizations involved in egregious or illegal activities, often a result of toxic corporate cultures that caused significant financial and reputational damage. Following earlier scandals, regulators have put in place controls such as assessments of internal control over financial reporting, CEO/CFO certifications, whistleblower requirements, and mechanisms to allow shareholders to hold management more accountable—all of which were intended to prevent further wrongdoing. Yet scandals still occur.

Because of the financial penalties, reputational damage, and other organizational impacts associated with significant business failures, it's not surprising that boards of directors are increasing their oversight of their organizations' culture. The U.S. Conference Board has called culture risk oversight "The Next Frontier for Boards." [1] Other organizations, including the Bank for International Settlements [2], the UK Financial Reporting Council [3], and the Financial Stability Board [4] have also issued guidance for boards on overseeing corporate culture.

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The culture enigma

Culture is a system of values, beliefs, and underlying assumptions that shape behavior both in the workplace and the surrounding environment in which the organization operates. However, obtaining a clear picture of an organization's culture isn't easy.

A survey Deloitte conducted for its 2016 *Global Human Capital Trends Report* highlights the challenges organizations face when addressing culture. While the survey found that 86 percent of respondents rate culture as either important or very important, and 82 percent agree that "culture is a potential competitive advantage," just 12 percent believe their organization is driving the right culture.

There are many reasons why assessing culture is a challenge. Since most organizations consist of multiple subcultures that vary from one operating region, business unit, or working team to another, a picture of the organization's overall culture is much like a mosaic. Because of these different subcultures, the "tone at the top" may be much different than the "tone in the middle" in each business unit or location. Even when organizations gain a snapshot of their culture, it isn't static—culture evolves.

Furthermore, an organization's culture is shaped by a number of factors, many of which cannot be controlled by or even known to the organization. For example, an organization's culture is impacted in part by people's individual values, attitudes, and behaviors, which may widely vary in today's increasingly diverse workplace.

"A significant challenge for every board is gaining a clear understanding of their organization's culture. Their objective should go beyond understanding *how* people feel about the things that are happening within the organization to understanding *why* those things are happening ." — **Veronica Melian, Global Culture Practice Leader**

The culture spectrum

When organizations proactively focus on culture, they often do so from one of two perspectives:

1. Organizations strive to build the type of culture that would best support and help maximize their ability to achieve strategic objectives. For example, an organization's desired culture may be one that is highly innovative or production oriented.
2. Organizations examine the potential risks associated with their culture that might undermine their ability to achieve strategic goals and growth plans, and then focus on implementing processes and controls to mitigate those risks.

While both of the above objectives are important, they need be considered together because culture is a continuum. Organizations may have strong positive cultures, highly toxic cultures, or cultures that are somewhere in between. While organizations may want to proactively shape a desired culture, changing cultural habits often takes considerable time. On the other hand, organizations need to mitigate the risk of a positive culture "tipping" into a toxic one, since a good culture can decay quickly.

An important consideration for boards is the ability to recognize the indicators of a culture at risk—when the organization's values and beliefs are not embedded or the ones that are embedded are not the right ones, resulting in behaviors that fail to respect stakeholders including customers, employees, suppliers, investors, and business partners—just to name a few.

One warning sign of a culture at risk is when financial, sales, production, or other performance measures become the primary business purpose, or when undue pressure is placed within the organization to achieve those metrics. When this occurs, employees could find themselves engaged in unethical or overly risky activities in an attempt to maximize misaligned management incentives tied to their compensation. In other cases, employees do so for fear of losing their jobs if they fail to meet aggressive sales, production, financial, or other targets.

Often the behavior of the organization's leaders can be a key indicator and driver of a failing culture. Leaders who fail to uphold the organization's values can create tensions that impact the ability to drive results. Failing to reinforce the organizational values, behaviors, and attitudes can create discord between the organization's image and how it operates. When performance and talent systems that reinforce desired behaviors are misaligned, that can disincent the behaviors that support the desired culture.

Culture indicators

To measure and analyze their culture, organizations need to look at a variety of indicators, which together may provide a dashboard or picture of the organization's culture and various subcultures. These indicators include:

- **Performance statistics**. Unexpected variations in sales results, growth, product orders or cancellations may provide indicators of cultural pressures on performance.
- **Human resource related statistics**. Analytics on employee turnover, absenteeism, and percentage of staff on extended leave may provide indications around the health of the organization's culture.
- **Feedback from other internal and external parties**. Observations from the organization's internal auditors, external auditors, legal advisors, and other groups could point to whether the organization's culture is at an optimal level.
- **Customer surveys**. Information about the quality of customer service and the customer's overall satisfaction with the organization may provide insights into culture.
- **Whistleblower program**. Important insights into the organization's culture can be obtained through the whistleblower program, or helpline. A common feature among many organizations whose cultures resulted in misbehaviors was a breakdown in their reporting processes. It could be that employees didn't know about the program, didn't trust the system, or the organization either ignored the complaints, or worse, took action to cover them up and punish the individuals who reported the problem.

Considerations for the board

As corporate culture continues to grow as a priority for directors, some key considerations for boards include:

Culture governance—Boards should make sure that they devote sufficient time for culture discussions, the need for which may vary depending on circumstances; mergers, acquisitions, or other restructurings that will have an impact on culture may require greater attention. Boards should also consider whether the lead oversight responsibility for culture should be assigned to a board committee and, if so, which one. The Financial Reporting Council also suggests that boards should consider whether the need to establish a special ethics/culture committee. [5]

Monitoring culture—Boards should be satisfied that they are getting the quantity and quality of information surrounding culture that is needed for their oversight purposes. The board should also consider the impact of its decisions on the organization's culture.

Public commitment—What information does the organization disclose about its culture and values, both internally to employees and externally to outside stakeholders through its filings, website, or other disclosures? The board should also make sure that the organization's activities and decisions are consistent with its stated culture and values.

Compensation practices—The board's compensation committee may wish to review the CEO's and senior management's compensation to ensure that no inappropriate activities are being inadvertently incentivized. The committee may also consider liaising with the organization's human resource group to gain an understanding of the overall structure of the organization's compensation system and to ensure it appropriately supports the overall business strategy.

Board and management oversight—Boards and senior management must set the appropriate "tone at the top"; they help shape the organization's culture through their words, actions, and behaviors. Together, they are responsible for ensuring that the values and beliefs of the organization's culture are upheld not only at the leadership level, but also throughout the organization.

While it is important that management keeps the board updated on the organization's culture, boards also have a responsibility for undertaking their own analysis to ensure that the tone at the top established by management and the board is actually being cascaded throughout the organization. Through proactive oversight by the board and management, organizations stand a better chance of identifying early warning signs of a toxic culture.

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A director's perspective

Why should corporate culture be a boardroom priority?
In 2014, Warren Buffett wrote a memo to the managers of Berkshire Hathaway in which he said: "Culture, more than rule books, determines how an organization behaves."

As directors, if we want to know how our organizations behave, we better understand and pay attention to their cultures.

We know that when an organization's culture and reward systems are aligned with its strategy and customers, good things happen. This alignment creates an energy that drives individual and team performance, innovation, customer loyalty, and value creation—which is what we, as directors, want.

But we also know that a toxic culture can undermine an organization's stated values, impede change, and support behaviors that damage financial performance, reputation, and brand. What is pushing culture onto the board's radar screen are the reports of corporate scandals where toxic cultures have been identified as the root cause. Obviously, no one wants their organization to be a victim of that, so directors are asking: what do we need to do to build a healthy culture and prevent a toxic culture from getting embedded in our organization?

However, we shouldn't become fixated on just the toxic/risk side of the culture spectrum; the real goal is building and sustaining a high energy healthy culture. So, as directors, we have a fundamental choice: we can either work with management to shape its culture or we can let the culture evolve on its own and shape the organization.

James L. Goodfellow, Corporate Director

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How should boards go about shaping their organization’s culture?
It’s actually management’s job to build and manage a healthy culture, but the board can play an important role.

First, the board’s role is to work with the CEO to develop and agree on the organization’s core values and the desired culture.

Boards also need to work with their CEOs to develop a compelling mission and vision for their organizations. Great companies have a “purpose beyond profit” that helps develop the kind of culture that attracts top talent, motivates people, and creates a powerful force for meaningful performance, not just within the organization but in the communities and countries in which it operates.

Once the organization’s purpose and core values are established, the board needs to make sure they are enduring and never compromised. That includes ensuring that, together with the right leadership and talent, the organization has a healthy culture that generates the energy needed for superior performance. When there is a danger of the organization, or parts of it, slipping into a toxic culture, boards need to see that management mitigates those risks and returns the organization to a healthy culture.

How important is the code of conduct?

Codes of conduct set out the organization's core values and, together with a compelling mission and vision, are the foundations of the board's culture expectations. So boards must put in place a clear and meaningful code of conduct that articulates the values needed to achieve the organization's strategies and build its reputation and brand. The code helps ensure that the board's expectations of the way business is to be conducted continues to be heard in the midst of the challenges of daily operations. Without a code, it's very unlikely people within the organization will understand the board's expectations—and if you don't have a code of conduct that sets out the rules, don't be surprised if people don't follow them.

However, a code of conduct alone isn't enough. For example, many of the organizations that have been victims of scandalous behaviors had impressive codes of conduct filled with all of the key values one would expect. The problem was, people weren't following the code.

An important test of a code of conduct is the way it is enforced and non-compliance issues are resolved, since this will impact how people view the organization's values and the impact those values have on the organizational culture. That means the code has to be universally applied across the organization without exceptions.

My message: don't develop a well written code of business conduct, post it on your website and declare victory.

Once these codes and statements are in place, what comes next?

What comes next is the hard work of shaping and sustaining a desired culture, which isn't easy because there are so many different dimensions.

For a start, an organization's culture isn't a monolith; it's almost always a combination of subcultures that differ from one part of the organization to another. The "tone at the top" may not always be reflected in the "tone in the middle" because middle level managers interpret—and in some cases, translate—the statements, goals, and expectations made by the board and management above for the people who report to them. Because this middle layer of management can either amplify or block upward and downward communications, and either resist or support programs initiated by senior management, there can be considerable differences among these subcultures. Getting them all operating in accordance with the organization's purpose and core values without compromises, local adaptations, or rationalizations as to why they are not relevant in one location compared to another is an ongoing job.

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Another challenge is the changing demographics in the workforce. For example, millennials have different motivations and expectations than baby boomers, and those differing expectations create tensions between the various workgroups. There is also an increasing proportion of women in the workplace and in leadership roles, which impacts culture because they differ in their behaviors and style as workers and leaders.

Digital technologies and robotics are disrupting the world of work, changing work processes and the way people interact with each other. In many industries, immigration is relied on to solve the skill shortages created by technological change and other factors. As a result, many domestic organizations have diversified workforces and must deal with the kind of global cultural challenges that used to be seen only in multinationals.

When you put all of these factors together, it is not surprising that Deloitte's Human Capital Trends survey found that most organizations are having difficulty diagnosing and managing their culture.

What would a healthy culture look like?

A healthy culture is a winning culture, by which I mean one that achieves the organization's purpose and strategies, and generates energy, excitement, and ongoing innovation. It's more than having low performing happy employees who would recommend the organization to their families, friends, and associates. It is also much more than just complying with laws and regulations—legal compliance is a given. Instead, it's a culture in which everyone is energized and brings their "A" game to work every day; they enthusiastically embrace the corporate strategies and goals, take pride in their work, learn from their failures, and work hard to "beat the competition."

How can a healthy culture create a competitive advantage?

Howard Schultz, the CEO of Starbucks, answered this question when he said: "The only competitive advantage we have is the culture and values of the company. Anyone can open up a coffee store." [6]

I believe a healthy culture can be an organization's "secret sauce" that creates a competitive advantage even when there are low barriers to entry. But, doing so requires hard work and leadership.

Boards need to ask questions like: do we have the leadership and talent to execute on our strategies? Are we organized in the right way to achieve our strategies and develop the capabilities of our people?

The "tone at the top" may not always be reflected in the "tone in the middle" because middle level managers interpret—and in some cases, translate—the statements, goals, and expectations made by the board and management above for the people who report to them.

They also need to understand what management is doing to create a winning culture that will make the organization unique. How does our culture match up against our competitors? Is management held accountable for both delivering their expected performance and achieving this performance in accordance with our values?

What role does compensation play in shaping culture?
Most boards believe in paying for performance. As directors, we want management to develop aggressive but achievable growth strategies, set stretch goals, innovate, develop people, and continually improve financial and operating performance. To encourage this behavior, organizations design a mix of equity-based incentive compensation systems for senior executives and more targeted incentive systems for sales and other groups.

That said, recent corporate scandals have highlighted the moral hazard risk inherent in all incentive compensation systems. When incentives are not designed or managed properly, we've seen people turn to unethical or illegal activities and behaviors so they can obtain their incentive pay or simply keep their jobs. We have seen that poorly designed or managed compensation systems can contribute to a toxic culture that, when combined with hiring, retention, and promotion practices that reinforce a toxic culture, can become deeply embedded in an organization.

For this reason, I believe boards and compensation committees should consider taking a closer look at how management ensures incentive systems are aligned with the organization's core values and that people are only rewarded for achieving performance targets when they do so in the right way.

I also think internal and external auditors should take into account compensation related risks, like the potential for incentive compensation systems to be "gamed" when stretch targets are perceived as unattainable, the way those systems might be gamed, and whether the organization's culture would support such behavior.

Finally, compensation committees should look beyond their compensation oversight challenges to address the talent, organizational design, and cultural issues we've been talking about.

How does a board monitor an organization's culture?
This is a something that could take a whole interview to discuss.

First, the overall objective should be to understand whether the organization's culture is healthy, toxic, or somewhere in between, and in what direction it is trending.

To do that, the board needs to have the right information. Organizations often gather data and make assessments that are directly or indirectly related to their culture. But are they assessing the right things and connecting the dots?

An organization's culture has a visible component that comprises actions, communications, behaviors, and reporting relationships. But like an iceberg, beneath the surface are values, feelings, beliefs, assumptions, and cultural norms that drive the visible behaviors. So what cultural component do organizations measure and monitor—and how often? Is it what is easiest to measure or what is most meaningful? At what levels and in what depth of detail is it measured? And what information does the board and its committees need vis-a-vis management?

When measuring culture, it's also important to remember the "Hawthorne Effect"—people in behavioral studies often act differently when they are being observed. So, to gain insights on "how things get done around here," you have to do it when nobody's looking. Not an easy task.

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Other considerations: Does the cultural assessment vary across business units, functions, and geographical locations? Are there any cultural "red flags" that might indicate serious problems? And what is management doing to strengthen the organization's culture and correct weaknesses?

So, there are a lot of planning, coordination and design issues to be addressed, from how the board and its committees allocate their work and responsibilities to supporting organizational culture.

Any final thoughts?
Yes, and it is a quote from Gwyn Morgan, who is a respected Canadian CEO, corporate director and commentator. In a newspaper article, he wrote: "Corporate culture must be built upon a bedrock of strong ethical values that penetrate every level in the company. It is said that corporate culture is defined by how people act when no one is looking. But it is also defined by how employees react when they see behavior that is inconsistent with the values of the organization. When their intrinsic cultural reaction is, 'We're not going to let this happen in our company,' the organization is built upon a solid ethical foundation." [7]

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Acknowledgments

The Deloitte Global Center for Corporate Governance would like to thank all of the professionals who assisted with drafting, editing, and reviewing this publication, including those listed below:

Co-authors: Chantal Rassart (Canada) and Hugh Miller (Hugh Miller Communications).

Lead Technical Reviewer: Michael Rossen (United States).

Technical Reviewers: Jacqueline Bukaluk Smith (Canada), Stephanie Chan Lok (Canada), Dan Konigsburg (United States), Veronica Melian (LATCO), Diane Ritter (Canada) and Shakti Singh Yadav (Canada).