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The tone at the top
Ten ways to measure effectiveness

If an entity's "tone at the top" could be measured and correlated with higher earnings quality and lower rates of financial reporting fraud and other serious wrongdoing, what directors would not want to measure that tone?

If similar techniques could be used to identify a division, a subsidiary, or a geographic area where employees believe management is paying lip service to compliance and ethics but did not "walk the talk" in their day-to-day actions, what compliance and risk management executives would not want to know where that was occurring and take remedial action before serious wrongdoing could affect the entity as a whole?

A supplemental research report for the 2009 National Business Ethics Survey states that, "In stronger as opposed to weaker cultures, pressure [to commit misconduct] is reduced from 16 to 4 percent…; rates of misconduct are roughly halved from 77 to 40 percent; failure to report declines from 44 to 27 percent and retaliation against reporters diminishes from a rate of 1 in 4 to 1 in 20."[1] (*The Importance of Ethical Culture, Increasing Trust and Driving Down Risks*, p 8, Ethics Resource Center, 2010)

Research and the evolution of practices suggest that evaluating the tone at the top is well established in certain entities, but there are still many entities that do not do it. Also, the evaluation methods used may be able to be improved in many cases.

[1] *The Importance of Ethical Culture, Increasing Trust and Driving Down Risks*, p. 8, used with permission of the Ethics Resource Center.

"The findings also indicate that tone at top perceptions and audit committee quality are positively associated with earnings quality."

Professors James E. Hunton, Rani Hoitash and Jay C. Thibodeau in "The Relationship Between Perceived Tone at the Top and Earnings Quality," (Accepted article, *Contemporary Accounting Research*, 2011)

Internal auditor's assessment of the tone at the top

In "Entity Level Controls: The Internal Auditor's Assessment of Management Tone at the Top" (Current Issues in Auditing, Vol. 3, No. 1, pp 1-13, 2009), professors James C. Hansen, Nathaniel M. Stephens and David A. Wood reported on their 2007 survey of 578 internal auditors. Seventy percent of respondents indicated that their internal audit function assessed management tone at the top and 80 percent indicated that they planned to do so in future.

The researchers found that respondents from entities that do assess management tone at the top rated the tone at their entity significantly higher than did respondents where no formal assessment takes place. This suggests that senior risk management executives at entities that do not assess management tone at the top might wish to have such an assessment performed.

The researchers expressed some concern about the level of internal audit personnel performing the assessments of management tone at the top, finding that only 55 percent of respondents indicated involvement of the chief audit executive. They were also concerned that over half of respondents indicated that the results were reported to management as well as to the audit committee and/or board of directors. The researchers felt this may be inappropriate as it may cause internal auditors to be less candid and forthright in their assessments. They cited previous academic research supporting this concern.

Ten ways to evaluate the tone at the top

There are at least 10 ways that directors, compliance and risk management executives, potentially assisted by advisors, can evaluate the tone at the top. A subset of these measures could be used initially, adding more techniques as earlier ones are mastered. An assessment of the tone at the top can be used as part of an entity's evaluation of controls for Sarbanes-Oxley reporting or for assessment of consistency with the compliance and ethics recommendations of the U.S. Federal Sentencing Guidelines.

Extent and nature of wrongdoing
Benchmarking against other companies the number and nature of known incidents of wrongdoing may highlight the extent to which management's tone at the top has led to compliance with the entity's policies. If management dismisses minor violations as unimportant, it may indicate a culture of noncompliance that could heighten the risk of more serious violations.

Use of anonymity in incident reporting
If the entity has a significantly higher than average proportion of whistleblower reports made anonymously, it may suggest that employees are afraid to report wrongdoing, or that employees believe that protection of previous whistleblowers has been inadequate.

Social media reputation assessment
Monitoring comments and criticism in social media and other online venues can help identify views of the entity's culture that could suggest an inadequate tone at the top. This review is also an important step in protecting an entity's reputation, brands, and shareholder value.

Employee surveys

Many entities use annual employee surveys to gather information on their employees' engagement with the enterprise and to monitor trends. These surveys can be conducted internally or performed with the assistance of an independent advisor. Carefully crafted questions can help in understanding employees' perspectives on whether senior management "walks the talk" on integrity and ethics. Assessing the responses enterprise-wide and for each unit, function, or geographical area can provide useful insight into areas that may require a renewed focus. Scores can be compared between units, benchmarked against those of similar entities, and compared from year to year to monitor changes.

Tone of management communications

Reading communications from management to employees for tone, in addition to content, may provide insight. Notice boards, office walls, and intranets may communicate a tone at the top quite different from the one on display in the boardroom.

Group discussion

Having a formal meeting agenda item for audit committee members, risk management or compliance executives to share their observations and perspectives regarding management activities, communications, and style may provide an opportunity to develop a cohesive perspective on the tone at the top. The discussion can lead to new insights and help build consensus on whether remedial action is needed, either in the tone itself or in communicating it effectively throughout the entity.

Facility visits

Rotating the location of board, compliance and risk management meetings can enable directors and executives to observe different parts of an entity's operations. Establishing contact with local management can facilitate future communication if issues arise. Audit committee members may choose to visit local management independent of a formal escort from the entity's head office. Informal conversations are, at times, the most illuminating.

Exit interviews

Some departing employees, concerned about burning bridges, may be unwilling to mention ethics and integrity issues that may have contributed to their departure. Others may welcome the opportunity to discuss their experiences, but may provide this information only if asked. There are several ways to solicit feedback from departing employees. For example, online surveys can be sent to former employees a few months after their departure, with capability for responding anonymously.

Interviews and focus groups

Interviews can be effective in assessing the tone at the top when they employ a structured approach and when people are comfortable stating their views openly, When employees are reluctant to talk, or when employee surveys identify potentially significant but nonspecific concerns, focus groups led by an independent third party may help uncover the underlying issues. Anonymous messaging and voting devices, together with an experienced facilitator, can help draw out information that people are reluctant to share openly.

Customer complaints

Monitoring trends in customer feedback may provide insight into the entity's culture. The swift and open handling of grievances may indicate an entity dedicated to compliance and ethics, while a pattern of customer's inadequate responses to customer grievances could suggest characteristics among management that research has associated with antisocial activities such as fraud.

Conclusion

Management's tone at the top is an essential element of effective internal control and corporate governance. It is also a foundation for developing a culture that supports employee and investor confidence. Compliance and risk executives can assist an entity's top management in measuring the tone at the top and taking actions to enhance effectiveness.

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Questions to consider

What quantitative measures are being used to complement qualitative evaluation of the tone at the top?

Is the entity's internal audit function performing assessments of "soft controls" that could be used to help evaluate the tone at the top?

How do the entity's processes for evaluating the tone at the top compare to those of other entities that are viewed as leaders in this area?

Are employees' perceptions of the tone at the top trending up, trending down, or flat? How do they compare with those of employees at similar or "leading" entities?

Are there operating units or functions where employees' perceptions of the tone at the top are much weaker than others? If so, why, and what remediation may be appropriate?

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