Managing Organizational Culture
For Effective Internal Control
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Professional guidance on internal control, such as the guidelines from the Committee of Sponsoring Organizations of the Treadway Commission (COSO), strongly emphasizes the importance of the “tone at the top”. Nevertheless, despite times of deep financial crises, we still often overlook how executives and senior management must combine their principles and practices to establish a tone that enhances effective internal control through all ranks of the business.

Culture can be driven by formal and informal controls if executives understand the balance between openness and closeness, and actively reinforce those cultural dimensions. Ignoring these cultural basics is likely to result in breathing space for detrimental cultures and an increased risk of internal control failures.

The Issue Alert will discuss how “tone at the top” imprints on an organization and why that imprint works. More specifically, it discusses the following points:

- What Sarbanes-Oxley and professional guidance on internal control do not adequately address;
- Why an understanding of the cultural forces underneath is important for effective internal control;
- How financial executives can manage organizational culture;
- Typical roots of control failures and 25 drivers for control effectiveness to address them;
- Integrating the cultural perspective;
- The real reasons why controls fail;
- Consequences for the financial executive: A tool to effectively combine the drivers;
- Lessons to be learned;
- Book contents;
- Book testimonials; and
- About the author.
What Sarbanes-Oxley and professional guidance on internal control do not adequately address

The causes of the current economic and financial crises and the occurrence of ever repeating accounting and business scandals throughout business history are often associated with “detached”, “corrupt” and “greedy” corporate cultures. Regulatory responses to control failures such as the Sarbanes-Oxley Act of 2002 (SOX) mention the importance of cultural aspects, but have often been criticized for missing the root cause of control failures. The argument goes that institutionally imposed formalization and documentation of financial control policies and procedures, such as required by SOX Section 404, is a cost-burden, and still cannot prevent the emergence of detrimental cultures. Professional guidance on internal control (for example, the COSO framework) also recognizes the relevance of the control environment and lists a number of best practices related to organizational culture. However, neither SOX (including the PCAOB and SEC guidance) nor the COSO framework provide much insight on how the cultural forces underneath interrelate with control and on the crucial role the financial executive plays in this interrelation as one of the key gatekeepers of organizational culture.

Why an understanding of the cultural forces underneath is important for effective internal control

Failure to understand key features of organizational culture and the inability to manage the tone at the top effectively increases the risk of establishing undermined “control” cultures. As a consequence, organizational cultures can establish their own dynamics which detach from their internal and external environments. Extreme examples of this include deeply corrupt cultures, dictatorial regimes and Mafia-like organizations. Members of these groups or organizations can be forced into behavior which they would highly detest outside the organization. To a lesser extent, these and other detrimental cultural characteristics can occur in any team, group or business if the tone at the top is not carefully managed.

The adverse implications of such cultures for the effectiveness of internal control are profound. For example, if the senior executives don’t promote an open tone via a combination of control drivers at all levels throughout the culture, important issues from the ground will not surface and misleading guidance by senior people will never be challenged and questioned by subordinates. In turn, too much openness may lead to inconsistencies and inefficiencies, and is likely to expose the culture to many unwished influences. Hence the executive needs to carefully balance what needs to be open and what needs to be closed, and cascade this throughout the organization.
How financial executives can manage organizational culture

Effective internal control starts at the top. While the requirement of specific policies and procedures can be prescribed and enforced by the regulator, ultimately it is in the hands of executives and senior management to significantly influence a culture that is supportive of effective controls. In doing so, financial executives should have a clear idea of how an effective tone at the top can be created, how culture interrelates with control, and how the tone will influence each individual in the organization, independent of physical location. This poses the following questions:

- What are the typical roots of control failures and which drivers of control effectiveness proactively address them?
- How should the drivers be combined to most effectively shape and influence a culture supportive of effective internal controls?
- Is being a successful financial executive in terms of culture simply a matter of intuition, or can some of these skills be learned via an understanding of how culture works?

Drawing from interviews with executives, senior managers and/or auditors from renowned companies (eBay, Google, Hewlett Packard, Intel, Levi Strauss & Co., Microsoft, Novartis and others) and theory from the fields of sociology and social psychology, the remainder of this issue alert presents selected contents from the author’s book entitled “Managing Organizational Culture for Effective Internal Control” (Springer-Physica 2009, 2011).

Here are two quotes taken from the book (p. 90):

“The key success factors to control effectiveness are leaders that lead by example and sensible internal systems that demonstrate trust and empower individuals.”

Eric Schmidt
Executive Chairman, Google
(quoted when Chairman and CEO of Google)

“Finally, leading and having a company in control is all about ethics. The living of ethical standards and leading by example.”

Erwin Heri
Former CFO of Credit Suisse Financial Services
(quoted when Chairman of the Audit Committee, Ciba Specialty Chemicals)
Typical roots of control failures and 25 drivers for control effectiveness to address them

Being aware of typical roots of control failures helps financial executives and managers at all levels focus their attention on key areas and proactively mitigate these potential sources of failures. From interviews with executives, senior managers and auditors from diverse industries, five broad categories of control failures are identified:

1. Failures of commitment: Uncommitted people do not act in accordance with organizational values, do not give full effort in day-to-day activities, and might risk the organization's interests for short-term opportunities.

2. Failures of competence: Because of inadequate skills, training or experience, people don't have the critical thinking, may create a “check the box” mentality, or lack the social skills that fit within the organizational environment.

3. Failures of communication: Inadequate communication can raise unclear expectations among organizational members, cause misunderstandings as to the benefits of particular activities, or create an environment where people do not speak up if control issues arise.

4. Failures of complexity: Complexity in structures, systems, regulations and tasks can make internal control so complex that individuals and groups are not able to design and execute controls properly.

5. Failures of change: Issues can be caused by new people coming into the organization, implementing new systems and structures, integrating a merger or an acquisition, facing a new regulation that is not understood in all its complexities, or by resistance to change more generally.

These five categories of failures provide a broad overview and indicate guidance on where financial executives should focus their attention. For each of these categories, the book presents five “drivers for control effectiveness”. These drivers represent what senior level people perceive as useful principles and practices to enhance effective controls. As illustrated in the table on page 5 (p. 89 in book), each category lists five drivers which amount to a total of 25 drivers.
### Table: Overview of Field Study Results

<table>
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<tr>
<th>Category of Control Failures</th>
<th>Driver for Control Effectiveness</th>
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<tr>
<td>1 Failures of Commitment</td>
<td>1 Lead by example</td>
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<td>2 Ingrain sustainability</td>
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<td>3 Deal with reality</td>
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<td>4 Define process ownership</td>
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<td>5 Ensure accountability</td>
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<td>2 Failures of Competence</td>
<td>1 Select appropriate qualification</td>
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<td></td>
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<td>5 Establish an attractive work environment</td>
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<td>3 Failures of Communication</td>
<td>1 Set clear and continuous messages</td>
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<td></td>
<td>2 Promote effective communication</td>
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<td></td>
<td>3 Explain benefits</td>
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<td>4 Encourage constructive debate</td>
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<td>5 Announce actions</td>
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<td>4 Failures of Complexity</td>
<td>1 Keep a holistic view</td>
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<td>2 Focus on risks</td>
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<td>3 Measure processes</td>
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<td>4 Establish consistency</td>
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<td>5 Embed controls</td>
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<td>5 Failures of Change</td>
<td>1 Monitor continuously</td>
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<td>2 Capture change</td>
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<td>3 Standardize change</td>
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<td>4 Take appropriate time</td>
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<td>5 Enhance a positive attitude</td>
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These drivers represent a checklist-like approach of drivers and a wide range of principles and practices that senior-level people perceive as crucial contributors to control effectiveness. While it is intuitively logical to many executives what the typical roots of control failures are and also which principles and practices “drive” effective controls, there is often a lack of awareness with regards to the implications on the culture. The study therefore further enhances those drivers and provides practical guidance on how they interrelate with organizational culture.
Integrating the cultural perspective

As one of the key gatekeepers of the culture, the financial executive plays a crucial role in creating and maintaining organizational culture. Organizational cultures are complex. They are the product of organizational phenomena and the meanings given to these phenomena by organizational members. Cultures are historically derived and are continuously emerging. Moreover, they are not only about shared patterns (e.g. shared values), but similarly characterized via subcultures, conflicts and fragmented elements. To make use of the cultural forces, the financial executive needs to have an understanding of basic cultural features. To assist with this, the study refers to sociological and social psychological theory and investigates how culture works, at the organizational as well as individual levels.

The organizational level: A key feature of how culture emerges and renews itself over time is the interaction within its environments. The external environment concerns influences such as market, technology and regulation. For example, if bribing is a common practice in a country the company operates in, this will be an external impulse on the culture and the organization will question whether to play the bribing game or not. Another impulse can be complex regulations which require a cultural response such as how detailed to deal with the regulation. In contrast, the internal environment represents the aggregate of personalities, job histories, values and other characteristics that board members, managers and personnel bring to the organization. For example, employees might not give full effort when executing controls, the implementation of a new system might fail because some employees were rushed, or new employees don’t understand their tasks due to high turnover and lack of training. All these environmental factors influence and interact with the culture. The executives have the tools to “open” and “close” the culture (see below) to these influences if they manage the tone via the drivers effectively.

The individual level: When focusing on the individual level, the interest is on how the culture affects each individual in performing controls. The interest focuses on what conditions does culture reinforce that people give their best effort and do not neglect the job? How can culture assure that people do not steal assets or otherwise behave in a way that does not support the organization’s long-term interests? Under what conditions do people follow their individual interests and under what conditions do they follow organizational interests in their control behavior? The individual brings in beliefs, values and other cultural traits (“how things should be done”). These values interact with organizational values. If both overlap, willingness to follow the organizational objectives will be high. If personal and organizational values conflict, then the individual will make a choice. The stronger the organizational values, the less likely the individual will pursue the individual values. Hence the executive needs to carefully reinforce the organizational values to make them strong.
The real reasons why controls fail

From studying culture at the organizational and individual levels, three key reasons why controls fail can be identified:

- **The culture is too closed:** A closed culture (one closed from outside influence) doesn’t allow any transfer between the culture and its environments. As a result, the cultures risk estrangement from its environments. Corrupt cultures build on behavior that many individuals that are part of the culture would not follow outside the company. Hence, the closed culture misses being evaluated and challenged by its internal (e.g. employees that speak up) and external (e.g. public, regulators, customers) environments and does not have to justify wrong behaviors.

- **The culture is too open:** A culture which is too open (incapable of closing discussion) may not reach consistency and control behavior that is efficient because no clear direction is given. In terms of internal control, such a culture will be inefficient and ineffective, reaching too much debate and not much clarity about the control policies and procedures. A culture that is too open will be undermined by heterogeneity, might consist of people following their own interests only, and will not be effective in making clear and timely decisions.

- **The culture is weak:** A weak culture is not strongly reinforced by the gatekeepers; as a result, the control behavior will not percolate throughout the organization. A weak culture does not reinforce what control behavior is accepted and what is not, and does not promote strongly enough that an open tone is necessary throughout all ranks of the business. Even worse, a weak culture might promote an open tone at the surface, but informally openness is not accepted.
Consequences for the financial executive: A tool to effectively combine the drivers

To manage organizational culture, or at least influence it significantly, an executive needs to have an understanding of how specific principles and practices influence its culture. More importantly, cultural knowledge needs to go beyond why specific drivers are relevant to the culture, i.e., how they interact and what combination of different types of drivers is necessary to best influence the culture. Thus, while there is no doubt that cultures are unique, there are some “universal laws” that are relevant to any organization and culture.

Considering these cultural aspects, the 25 drivers for control effectiveness are re-evaluated based on their cultural meaning. As illustrated in the figure below (p. 163 in book), they are divided into closing, opening and reinforcing drivers:

**Closing drivers** clearly define how controls need to be performed and set organizational members’ limits. Closing drivers offer advantages that provide guidance to organizational members on how controls need to be performed, establish consistency in control behavior throughout the culture and define what behavior is unacceptable in the culture. For example, the driver (1-2) “Ingrain sustainability” closes the culture to solely short-term thinking and the driver (5-4) “Take appropriate time” closes the culture to rushing the implementation of changes. These examples close the culture because executives clarify that, on the one hand, long-term thinking and, on the other hand, taking appropriate time, are both important to them.
Opening drivers assure that the opinions of organizational members are considered in designing and executing control within their area of responsibility. They have the advantage that constructive debate takes place, which can continuously evaluate and improve controls, more opinions are considered and, as a result, internal control can become more effective. Leaders and followers cannot easily rationalize ineffective (i.e., corrupt) behavior because they need to justify these behaviors to internal and external parties. For example, the driver (1-4) “Define process ownership” opens the culture by giving employees autonomy of controls within their control area. The driver (3-4) “Encourage constructive debate” opens the culture to criticism and knowledge sharing within and towards the outside of the organization.

Reinforcing drivers manifest and disperse the content of closing and opening drivers via the culture through leadership, selection and socialization processes. These reinforcing drivers make the culture strong by promoting the other two drivers. For example, the driver (1-1) “Lead by example” strengthens the culture by role modeling the application of closing and opening drivers. The driver (3-1) “Set clear and continuous messages” reinforces the culture by setting clear messages about the closing and opening drivers within the organization.

Closing and opening drivers can only be effective if they are re-emphasized throughout the culture by reinforcing drivers. Balancing opening and closing drivers provide the cultural dimensions for control, while reinforcing drivers make the culture stronger. Having a good understanding of how the 25 drivers of control effectiveness interrelate, financial executives can actively create and shape a tone at the top which manifests and disperses throughout the organization.
Lessons to be learned

1. Culture is powerful and fundamentally interrelated with control. The financial executive plays a crucial role in this relation as one of the key gatekeepers of the culture.

2. Culture can be managed from the top via formal and informal controls if financial executives are aware of the cultural meanings of each type of control (here drivers) and how to combine them most effectively.

3. Financial executives are critically challenged to find the right balance between closing and opening drivers. Closing drivers provide a top-down direction, while opening drivers promotes a bottom-up control mechanism. Balancing these two extremes is crucial for the direction, but also the critical evaluation, of the culture.

4. In order to balance the drivers, financial executives and managers at all levels need to be open (at least to some extent) to challenges and critical questions from subordinates, and promote a culture where people can speak their minds.

5. While there is a general understanding that culture can be reinforced via leadership, selection and socialization, for financial executives it is particularly important to be aware of the psychology of such reinforcing drivers on each individual in their decision making, even when they seem to be far away and remotely located in the organization. Employees are likely to rationalize personal interests if the organizational direction is not strongly promoted.

6. A strong (reinforced) culture is most supportive to effective internal control if it remains open minded. Strong closed cultures are most detrimental as they establish their own dynamics and detach from their environments (e.g., they become corrupt). The successful application of reinforcing drivers is therefore dependent upon the careful balance between opening and closing drivers.

7. The seriousness of ever repeating control failures such as at Enron, WorldCom, Siemens, UBS, Lehman Brothers, etc. (this list will be continued in the future) shows that financial executives and managers at all levels should give careful attention – to how to establish a culture for effective controls in order to deliver long-term financial performance.

8. The framework presented is an attempt to focus the relation between culture and control to key features so that executives have a simple tool to achieve a high outcome in establishing a culture for effective controls.

9. As a consequence, as much as financial executives focus on a portfolio of growing techniques, performance measures, investment plans, accounting standards, or other compliance issues, they should also give adequate attention to the “tone at the top” and how the cultural forces can be established to enhance effective internal control throughout all ranks of the business.
Book Contents

Managing Organizational Culture for Effective Internal Control” (Springer-Physica 2009, 2011).

The book has an introductory chapter which lays out the purpose and objectives of the study. The remaining eight chapters are divided into four parts.

Chapters two and three cover the basics. Chapter two introduces internal control (e.g., definitions, historical development, organizational governance) and organizational culture (e.g., static versus dynamic views). Chapter three reviews the practical literature on internal control with regards to culture including the frameworks from the Committee of Sponsoring Organizations of the Treadway Commission (COSO), the Canadian Guidance on Control Board (CoCo) and the British Turnbull Report. It also reviews the management accounting and control literature with an emphasis on the control frameworks from Ouchi, Merchant, and Simons.

Chapter four presents the field study. In total, 31 interviews across 21 companies from multiple industries and levels of senior management were undertaken in the U.S. and Switzerland. The findings provide a broad overview of principles and practices that managers can apply to drive control effectiveness. Based on the discussion, five categories of control failures are identified (commitment, competence, communication, complexity and change), and each category contains five drivers which amount to a total number of 25 drivers.

Chapters five to seven consider theoretical explanations to further develop the empirical findings from chapter four. Chapter five provides details on the choice of theories, and distinguishes the need to study culture at the organizational and individual levels. Building on the theory of social systems, chapter six analyzes culture at the organizational level with an emphasis on its external and internal environments. Based on value theories, Chapter seven looks at individual levels and analyzes the interactions between individual and organizational values.

Chapter eight synthesizes prior insights and presents a framework to establish a culture that enhances effective internal controls. It builds on drivers that can include formal and informal control mechanisms. The typology consists of closing drivers, opening drivers and reinforcing drivers. The classification criteria are therefore cultural in meaning. Chapter nine provides a conclusion with key results, distinctions from other frameworks, and implications for academics and practitioners.

Book availability: The book (245 pages, 32 illustrations, 23 tables) is available at amazon.com and other booksellers in the following formats:

- Hardcopy (released 14 July 2009)
- Paperback (released 31 December 2011)
- Kindle (released 14 July 2009)

http://www.amazon.com/Managing-Organizational-Culture-Effective-Internal/dp/3790827851/ref=tmm_pap_title_0?ie=UTF8&qid=1326041767&sr=1-1
Testimonials

“Dr. Pfister sheds new light on the critically important, but often-overlooked, "softer" forms of control, such as corporate culture. And he does it in a rigorous and engaging way. A very worthwhile read!“
Kenneth A. Merchant, Deloitte and Touche LLP Chair of Accountancy, University of Southern California

“In our increasingly complex and multicultural world it is high time that someone tackles the implications of different assumptions among the team members in finance and accounting groups.”
Edgar H. Schein, Professor Emeritus, MIT Sloan School of Management

“Dr. Pfister provides a well-written, accessible and comprehensive overview of the control environment and identification of the key practical drivers highly useful to managers in implementing controls and creating culture; and which auditors and boards can use to assess the quality of the control environment: the organizational culture.”
James Wall, retired CFO Core-Mark International, Trustee, Financial Executives Research Foundation

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