

Audit Committee Brief



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*Steve Van Arsdell,
chief executive officer,
Deloitte & Touche LLP*

Evaluating the Tone at the Top: Practical Suggestions for Audit Committees

If a company’s “tone at the top” could be measured and correlated with rates of financial reporting fraud, what audit committee member would not want to measure that tone? If similar measurements could be used to identify a division, subsidiary, or geographic area where employees believe management is paying lip service to compliance and ethics, what audit committee member would not want to know where that was occurring and take remedial action before serious wrongdoing could affect the company 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 audit committee’s influence on management’s actions and the tone at the top cannot be understated. I have seen the positive impact that an engaged audit committee can have on maintaining and enhancing a strong corporate culture,” noted Steve Van Arsdell, chief executive officer, Deloitte & Touche LLP.

Activities to Evaluate the Tone at the Top

Although many companies evaluate the tone at the top while assessing the control environment, some audit committees may find a more specific focus in this area is warranted. It is the audit committee’s responsibility to understand how management evaluates its performance in setting an appropriate tone and creating a corporate culture that supports workplace integrity. The audit committee should meet with the chief audit executive or another appropriate member of management to discuss what procedures are in place to evaluate the tone at the top and to discuss the effectiveness of the assessment process, as well as to coordinate assistance in the activities discussed below. The audit committee could also consider hiring a third party adviser to independently perform certain activities related to evaluating the tone at the top.

Each company is different, and there are many potential methods for audit committees to understand the tone at the top as part of their responsibility to oversee the integrity of the company’s financial statements. Using more than one approach is recommended in order to develop a complete and balanced view of the corporate culture and tone at the top from multiple perspectives. The audit committee should have a good understanding of management’s approach and recommend additional actions where warranted. Below are a number of different activities an audit committee may consider in performing an overall assessment of management’s tone at the top.

¹ Copyright 2010, *The Importance of Ethical Culture, Increasing Trust and Driving Down Risks*, p. 8, used with permission of the Ethics Resource Center.

Questions for Audit Committees to Consider

- What processes does management have in place to evaluate the tone at the top?
- Is the internal audit function assessing “soft controls,” those controls focused on the motivation of employees and management style that could be used to help the audit committee evaluate the tone at the top?
- How do management’s and the audit committee’s processes for evaluating the tone at the top compare to those of other companies that are viewed as leaders in this area?
- Does the audit committee use quantitative as well qualitative measures in evaluating tone at the top?
- 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 companies?
- 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 is management implementing?

Analyze Hotline Activity

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 company’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. Additionally, if the company has a significantly high proportion of anonymous whistleblower calls, it may suggest that employees are afraid to report wrongdoing or that employees believe that protection of previous whistleblowers has been inadequate.

Employee Surveys

Many companies use annual employee surveys to gather information on their employees’ engagement with the company and to monitor trends. These surveys can be conducted internally or performed with the assistance of an independent adviser. 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 companies, 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. Lunchroom notice boards, office walls, and intranets may communicate a tone at the top quite different from the one on display in the boardroom.

Audit Committee Discussion

Having a formal meeting agenda item for audit committee members to share their observations and perspectives regarding management activities, communications, and behaviors 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.

Social Media Reputation Assessment

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

Facility Visits

Rotating the location of board meetings can help directors observe different parts of a company’s operations. Establishing contact with local management can facilitate future communications with the audit committee if issues arise. Audit committee members may choose to visit local management independent of a formal escort from the 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.

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 corporate culture. The swift and open handling of grievances may indicate a company dedicated to compliance and ethics, whereas a pattern of 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. The audit committee, in its oversight role, has a responsibility to evaluate management's ability to set and communicate this tone consistently in order to maintain an environment of corporate integrity.

Recent News

On May 25, 2011, the SEC issued final whistleblower program rules. Employees with knowledge of potential securities fraud who report original information to the government or a self-regulatory organization can receive a minimum of 10 percent and as much as 30 percent of monetary sanctions if the enforcement action results in sanctions of at least \$1 million.

Whistleblowers are not required to first report issues through internal company channels; however, those choosing to do so are still eligible for the reward if the company reports the problem to the government or if the whistleblower does so within 120 days of notifying the company.

The audit committee may want to consider discussing with management:

- Opportunities to enhance internal whistleblowing systems
- The potential advantages of implementing timely internal whistleblower cash awards to sustain and encourage internal whistleblowing
- The potential value of transaction monitoring tools to help promptly identify potential securities fraud issues such as bribery or financial statement fraud
- Possible budgetary impacts, since this legislation could boost whistleblower activity and the number of fraud allegations a company may have to investigate.

Additional Resources

Deloitte's [Audit Committee Resource Guide](#)

Deloitte CFO Insights: [Whistleblowing after Dodd-Frank: New Risks, New Responses](#)

Deloitte's Risk Intelligent Governance: [A Practical Guide for Boards](#)

[Risk Oversight in a Changing Regulatory Environment](#), Boardmember.com

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