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How your board can influence culture and risk appetite

Boards understand that corporate culture is vital. It drives behavior, expectations and norms—but it can also lead employees to take too much or too little risk.

Understanding culture is difficult. It's especially tricky for directors to know whether the culture supports the right kind of risk-taking. Aggressive compensation targets or growing numbers of whistleblower complaints may be signs that a company's culture is out of control. Does your board have a handle on company culture?

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Recognizing the importance of culture and risk appetite

We've all read headlines about companies that took bets involving levels of risk they didn't fully understand, or that overstepped ethical boundaries. There's also concern about taking on too little risk and missing opportunities for performance and growth. In light of what they see happening, it's not unusual for directors to wonder: How much risk does our company need to take to succeed? What roles should the board and the CEO play in setting culture? And how do we know our culture is promoting the right behaviors and encouraging employees to take appropriate risks?

Before we go any further, we need to recognize that the culture problems that may seem obvious in hindsight are less easy to see when a company is going about its day-to-day business. But shareholders, regulators, the media and even customers don't care if it's difficult— they'll want to know why a board didn't take action on items they believe it should have known about. The tricky issue is how to spot evidence of culture problems before a crisis erupts and those problems become all too evident to stakeholders.

Addressing the key challenges for directors

How can directors understand an intangible subject like culture and figure out whether the culture is appropriate for the company?

Board action: Get the information you need to understand the company's real culture and insist management work to improve it, if required. Re-think which metrics can help the board assess the culture.

What's the board's appropriate role in setting risk appetite, so directors can better understand the amount and type of risk the company is taking?

Board action: Weigh in on risk appetite until you're satisfied it reflects the appropriate amount of risk-taking.

How well do directors understand how management handles conflicting goals and mixed messages that can muddy decisions and create unintended consequences?

Board action: Challenge executives on how they prioritize conflicting objectives.

Challenge: How can directors understand an intangible subject like culture and figure out whether the culture is appropriate for the company?

Board agendas are full, and culture is often "squishy"—difficult to describe and understand. But ignoring culture prevents directors from understanding how it drives what people are doing.

What is culture?

It's the set of common assumptions or beliefs in a company that allow you to predict how people will behave and what they will achieve.

An effective culture promotes appropriate risk-taking and transparency with a clear, consistent, ethical tone at the top, which filters through to all employees. Financial services regulators and others are looking more carefully at culture, especially in the aftermath of the 2008 financial crisis. As former SEC Chair Mary Jo White noted, "Deficient corporate cultures are often the cause of the most egregious securities law violations." For instance, the wrong compensation structure can derail a culture—we've seen too many companies incentivize the wrong behaviors.

What happens when the culture is poor? There may be out of pocket costs in the form of fines. Indeed, in 2016, several companies were fined by regulators or government agencies for wrongdoing, in some cases prompting governments and institutions to question doing further business with these companies. Such situations point to the real cost of a poor culture: damage to a company's reputation that can be long-lasting. Whether or

not the issue is significant in regulators' eyes, the response from customers, employees and the public can be devastating.

The issue of culture is important for another reason. Companies that operate in the United States are subject to the Federal Sentencing Guidelines. Those Guidelines establish penalties if a company is found guilty of wrongdoing. But more importantly, they allow the courts to reduce the fines if a company has an effective compliance and ethics program. To be considered "effective," a program has to promote a "culture that encourages ethical conduct and a commitment to compliance with the law."

Compliance and ethics executives see inconsistent support from leadership

98%
say their company's senior leadership is committed to compliance and ethics
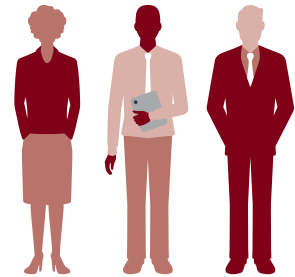
yet

55%
say senior leadership's involvement in the compliance and ethics program is either ad hoc or delegated.

Source: PwC, *State of Compliance Study,* 2016.

There are many reasons why boards may find it challenging to distinguish what's just noise in the system from what's a more significant culture problem.

- The C-suite may say all the right things in the boardroom but middle managers might send a different message to employees. That "mood in the middle" is trickier to figure out.

- Board presentations are carefully vetted and edited, and may not include all of the relevant issues.

- Trends or patterns in whistleblower complaints may be explained away as being from disgruntled employees or caused by one manager who's been fired. Even reports that tell you about the number of hotline calls don't necessarily reveal that some managers may be pressuring employees to take outsized risks. Plus, there's evidence that many issues are reported directly to middle management, so boards don't necessarily hear about them unless they're escalated.

- Employees aren't necessarily driven by incentive compensation—they may just be focused on trying to please their supervisor.

- Having all the right rules, policies and checklists don't by themselves impact how employees behave. So much hinges on *how* people meet performance goals.

> ## "Culture eats strategy for breakfast."
> – Attributed to Peter Drucker

- Many companies get numerous whistleblower complaints or experience significant employee departures. But it's not clear when these go beyond "normal" and signal a deeper problem.

- Different parts of the company may have different cultures. That's especially true after acquisitions. If directors don't have access to employees throughout the company, they can't see these differences.

Finally, it's difficult for directors to recognize the culture might be bad because to do so they have to overcome their innate belief that the CEO is behaving properly. After all, they hired the CEO and wouldn't serve on the board if they didn't trust management. But since the risk of wrongdoing is never zero, directors have to be open to the possibility that things are going wrong. In the company. Right now.

***Board action:** Get the information you need to understand the company's real culture and insist management work to improve it, if required. Re-think which metrics can help the board assess the culture.*

Culture is difficult to assess, but past crises have shown one clear red flag. If the company's results are way better than any of its competitors, directors need to be skeptical. Time and again it has turned out that companies that looked like superstars weren't. They were driving bad behavior to meet unrealistic goals in an unsustainable manner, or were outright manipulating their results. So directors in outperforming companies should probe how management has been able to achieve superior results. And keep probing. That may lead you to discover that the company is simply taking too much risk, or worse, doing things it shouldn't be.

Culture isn't aspirational—it's how people are acting today. To better understand current culture, boards can:

- Ensure the topic is on the board's agenda so directors spend the time needed to focus on it.

- Ask how performance targets are set and how related incentives are determined to explicitly connect compensation plans to risk-taking.

- Review a standard "dashboard" regularly that tracks elements of culture and probe why measures have—or haven't—changed. Measures might include the results of employee culture surveys or employee engagement scores.

- Challenge management on risks they are taking during strategy and performance reviews.

- Ask for examples of how disciplinary actions were applied and ensure they are consistent regardless of whether or not someone is a top performer.

- Review reports and trends from whistleblower hotlines, regulators and exit interviews. These can give you a heads-up on problems that may be brewing.

- Get feedback on culture in private sessions with the chief audit executive and the chief compliance officer to see if they have noticed any anomalies.

- Consider requesting a culture assessment periodically—either by internal audit or an outside party.

- Discuss how a significant change—a new strategy or a major acquisition—impacts culture.

- Discuss tone at the top with the CEO and other top executives. Look for whether the CEO reinforces it consistently. Check that managers continually demonstrate ethical behavior and that employees feel able to speak up without fear of reprisal.

- Discuss results of the CEO's 360 degree evaluation, being on the lookout for any evidence that he or she is creating a toxic environment. For example, a high rate of senior executive departures could be a sign that the CEO is placing unreasonable pressure on the management team.

- Meet with employees outside of the boardroom. Take advantage of board meetings held at different company locations to do so.
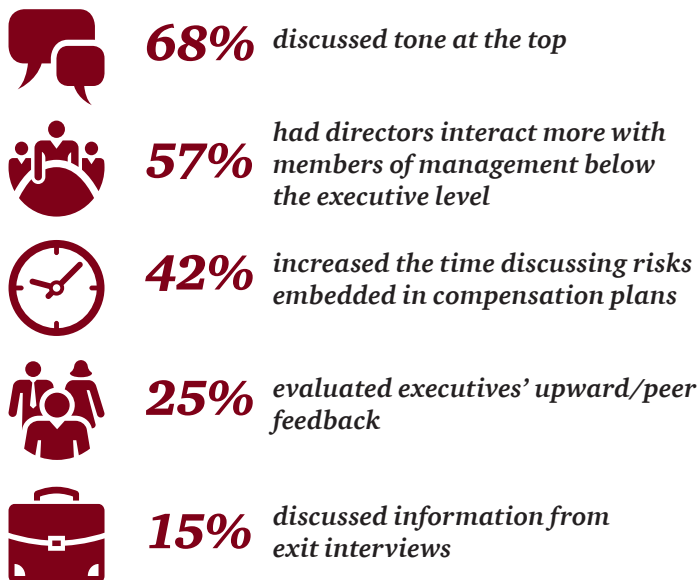
How can directors use whistleblower complaints?

Whistleblower hotlines are important starting points to let directors know when there may be problems brewing. If there are obvious patterns—the same types of complaints or caller location, for example—dig deeper into what may be going on. If most of the calls are classified as HR-related, have a conversation with the chief human resources officer to find out the causes of the complaints. And let management know when you think certain complaints deserve investigation. Boards may want to start their own investigations if they think something meaningful isn't being disclosed or properly managed.

Room to improve board engagement with culture

Directors report:

68% *discussed tone at the top*

57% *had directors interact more with members of management below the executive level*

42% *increased the time discussing risks embedded in compensation plans*

25% *evaluated executives' upward/peer feedback*

15% *discussed information from exit interviews*

These are not "one and done" discussions. Without attention, a good culture can drift over time, so this needs ongoing board—and executive—attention.

Ideally, probing into the culture will reassure the board that it's satisfactory. But the reality is that some boards will get results that cause concern. When allegations of wrongdoing are widespread, it's hard to write them off as being caused by just a few bad actors. And it's unclear that simply dismissing or punishing individuals fixes the problem. How do you drive a needed change in culture?

- Agree on exactly what it is about the current culture that needs to change.

- Ask the CEO about his or her plans to improve the culture. Get specifics, including timeline commitments. Actions might include:

  - Examining the operating model to flag processes or handoffs along the value chain that may lead to riskier behavior.

  - Rethinking performance targets and incentives structures and their impact on behaviors.

  - Outlining plans to engage with the broader workforce and gain employee buy-in.

  - Defining the performance metrics that will track the degree of culture change achieved—possibly through regular surveys or focus groups.

  - Hiring a consultant to assess the culture and advise on improving it.

Finally, there's always the nuclear option: replacing senior leaders. If the culture is toxic. If the board suspects senior leadership knew about the problems yet did nothing. Or if the board doesn't believe the current leaders can right the ship. But recognize that new executives alone may not be enough to change the culture.

Follow the money

Tying performance targets to incentives should help drive the right behaviors, but sometimes that simply isn't the case. Be sure to have management re-examine the many ways in which targets that are solely focused on revenue growth or the bottom line can drive the wrong behaviors. There are too many instances when even senior management can be blinded by superior returns that may come from engineering shortcuts or selling to phantom customers. If it seems too good to be true, follow the money. It may be your compensation plans that are at the root of the problem.

Challenge: What's the board's appropriate role in setting risk appetite, so directors can better understand the amount and type of risk the company is taking?

Instinct drives risk-taking at many companies. Most people have a sense of how they should behave and what risks are acceptable. But how can senior management and the board know everyone is on the same page when it comes to taking risks? It comes down to risk appetite. Management can let people know how much risk is okay in trying to achieve objectives by articulating its risk appetite. That said, some chief risk officers are reluctant to develop one because they see it as an academic exercise that ends up on a shelf. But despite possible reluctance, a risk appetite statement can provide insight into the types and amount of risk that are seen as suitable.

Few companies have a formal risk appetite statement
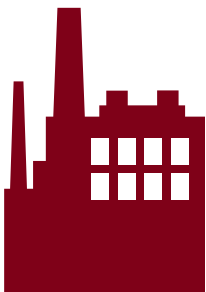
23%
of companies excluding the financial sector

35%
of all companies

Source: NACD, *2015-2016 Public Company Governance Survey*, 2015.

Risk appetite statements differ for financial services companies

Formal risk appetite statements are slightly more common in financial services companies, largely driven by regulatory requirements. Along with some qualitative factors, they often quantify the acceptable ranges of specific risks in areas such as credit, market and liquidity. These kinds of statements make it easier for regulators to gauge whether a particular institution is taking too much risk.

Board action: *Weigh in on risk appetite until you're satisfied it reflects the appropriate amount of risk-taking.*

If there isn't one already, decide whether management should craft a formal risk appetite statement—to provide a framework for risk-taking. Ensure it fits the strategy and informs business decisions. Regular risk appetite reviews should be part of board risk oversight. Make sure risk appetite and culture are aligned.

Encourage management to create a risk appetite structure that reflects the interaction of multiple risks. Directors can plan regular discussions about risk interactions and how they impact the stated risk appetites.

Recognize that management may need to revisit, refine and revise risk appetite as the company's strategy changes and as enterprise risk management (ERM) evolves within the company.
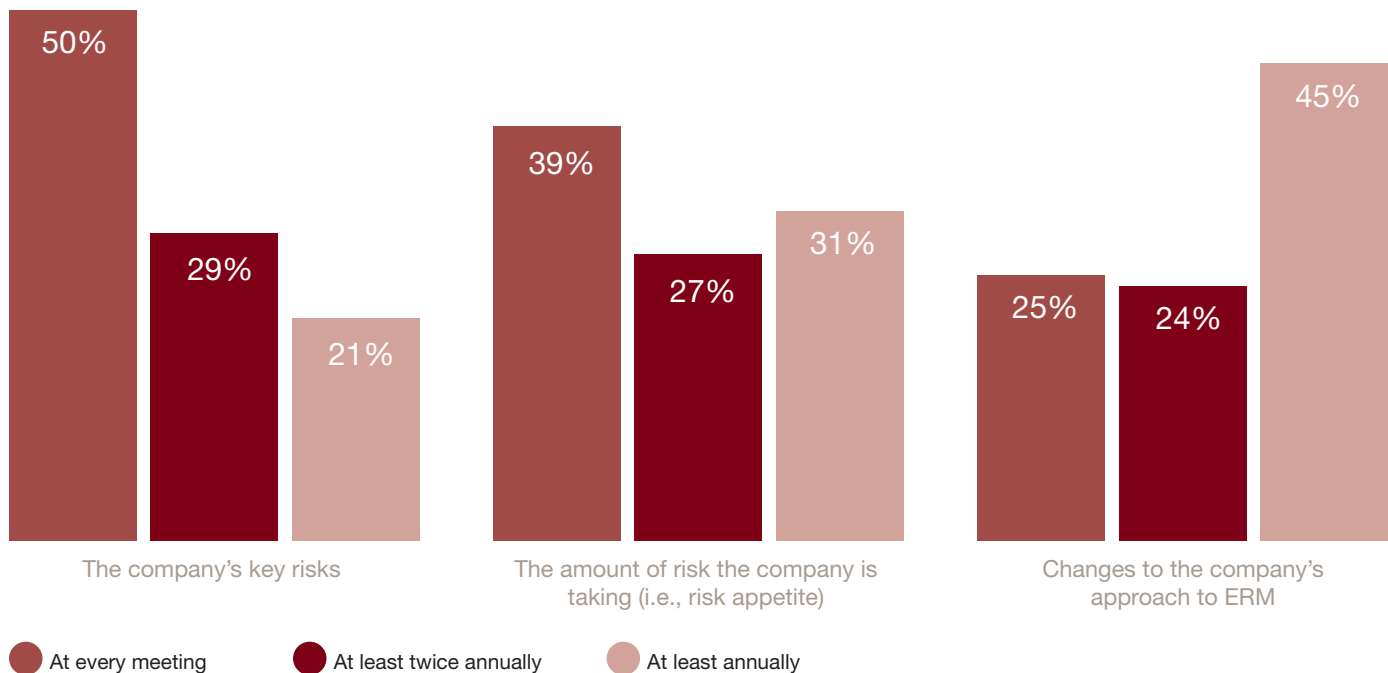
Ask management to notify the board when risk moves outside acceptable levels so directors can discuss the impact on strategy and performance. Accountability for risk-taking can be tricky. Sometimes taking even reasonable risk has a negative outcome. But boards should hold managers accountable when people take risks that are well outside the bounds of the established risk appetite. And that even includes when those risks pay off.

What makes a good risk appetite statement?

A good risk appetite statement will promote a healthy culture and aid in decision-making. It becomes a company playbook for how much uncertainty is acceptable. It sets the boundaries of how much risk to take to meet strategic and operating objectives. (Those boundaries will be different for different kinds of risks.) Indeed, it may take several sentences to express how much risk is needed (floor) and how much is acceptable (ceiling) to achieve objectives. In summary, it makes risk-taking more transparent.

For examples, see the Defining Risk Appetite section of COSO's 2017 *Enterprise Risk Management—Aligning Risk with Strategy and Performance.*

Boards get regular updates on the amount of risk the company is taking

	The company's key risks	The amount of risk the company is taking (i.e., risk appetite)	Changes to the company's approach to ERM
At every meeting	50%	39%	25%
At least twice annually	29%	27%	24%
At least annually	21%	31%	45%

● At every meeting ● At least twice annually ● At least annually

0–1% of directors responded 'Don't know';
1–6% of directors responded 'Never'

Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

Challenge: How well do directors understand how management handles conflicting goals and mixed messages that can muddy decisions and create unintended consequences?

The reality is that even getting the culture and risk appetite "right" doesn't solve everything. Business complexity and conflicting objectives mean management has to make decisions that involve trade-offs. What kind of trade-offs? For example, employee safety may be a core value, but pressure to make quarterly numbers could discourage investments in improving safety.

Some argue that having conflicting goals is the right way to go—as it inherently helps manage risk. To take the earlier example, if the company doesn't have safety targets that counterbalance earnings targets, workplace or product safety could decline substantially. That could not only hurt people, it could damage the company's brand. And even with the "right" conflicting targets, if compensation programs are poorly designed, they won't support appropriate behavior.

How can boards know that management is making appropriate trade-offs between different objectives? The right culture and aligned risk appetite can help, but directors can't stop at those high level indicators of risk-taking.

Board action: *Challenge executives on how they prioritize conflicting objectives.*

Directors need to understand how management resolves the tension of conflicting objectives and monitors decision-making in the absence of clear guidelines. One technique management can use is to design code of conduct training using stories to help teach how to make the best decision when a situation is ambivalent. Conversations with employees outside the C-suite can let you know if the culture feels right.

In conclusion...

The right culture gives the board and management
confidence that employees will do the right thing
in tough situations. And communicating the
risk appetite helps management throughout the
company understand how much risk is acceptable
in pursuing the company's objectives. Both are
vital components to a board's effective oversight
of risk.

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Other "Risk Oversight Series" topics include:

- *Why your board should take a fresh look at risk oversight: a practical guide for getting started*

- *How your board can ensure enterprise risk management connects with strategy*

- *Why your board should refocus on key risks*

- *How your board can decide if it needs a risk committee*

- *How your board can be ready for crisis*

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