



# Governing culture:

practical considerations  
for the board and its  
committees

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# The role of boards and committees in governing culture

What roles do your board and your main board committees play in shaping and monitoring your organisation's culture? What questions should they be asking themselves and management about organisational values and purpose, employee behaviours and attitudes, reward structures and the way things are done? What observable and measurable indicators do your board committees use as a proxy for assessing culture? Your responses could indicate how effectively your board and committees are addressing the impact of organisational culture on corporate performance.

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**This paper is designed for anyone considering such issues and seeking to ensure that culture receives appropriate governance focus at board and committee level.**

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This is a hot topic in the UK, and has been since the financial crisis. In examining the underlying causes of corporate failings, many commentators began to reflect on the role of corporate culture in decision making. Questions were also asked about the quality of corporate governance and board oversight of cultural issues.

Board and committee focus on culture reflects growing regulatory interest in the area. The Financial Reporting Council's September 2015 market-led initiative, 'the Culture Coalition', set out to gather insights and promote leading practice. This has prompted research and analysis from a variety of stakeholders. EY has responded with *The route to risk reduction: better rules or better decisions?* (March 2016), which clearly illustrates how a focus on culture can decrease risk and improve performance.

In another contribution to the discussion, the Institute of Business Ethics' 2016 paper *Culture by committee* outlines the pros and cons of a board committee dedicated to oversight of corporate culture.

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**We can see some advantages to such a committee, particularly for focusing attention on culture when needed for a specific period. However, we believe the board and all the board committees are responsible for considering the extent to which the culture of the organisation affects matters within their terms of reference – either directly or indirectly.**

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The board of directors is ultimately accountable for defining and monitoring corporate culture, while each board committee also has an active role in examining the decisions it makes and oversight it exercises through the lens of culture.

This paper follows on from EY's previous work by focusing on culture from a governance perspective.

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**It looks at how the board and its committees can embed a consideration of culture into their thinking by asking key questions. It aims to stimulate constructive discussions about the impact of the various organisational pillars – the political, social, performance and operational architectures.**

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We hope this paper will provide a practical and effective tool for all boards and committees seeking to embed desired cultures throughout their organisations. To this end, we have provided space for notes, follow-up points and reflections throughout. We look forward to hearing any feedback on the questions we suggest and the discussions that they encourage.

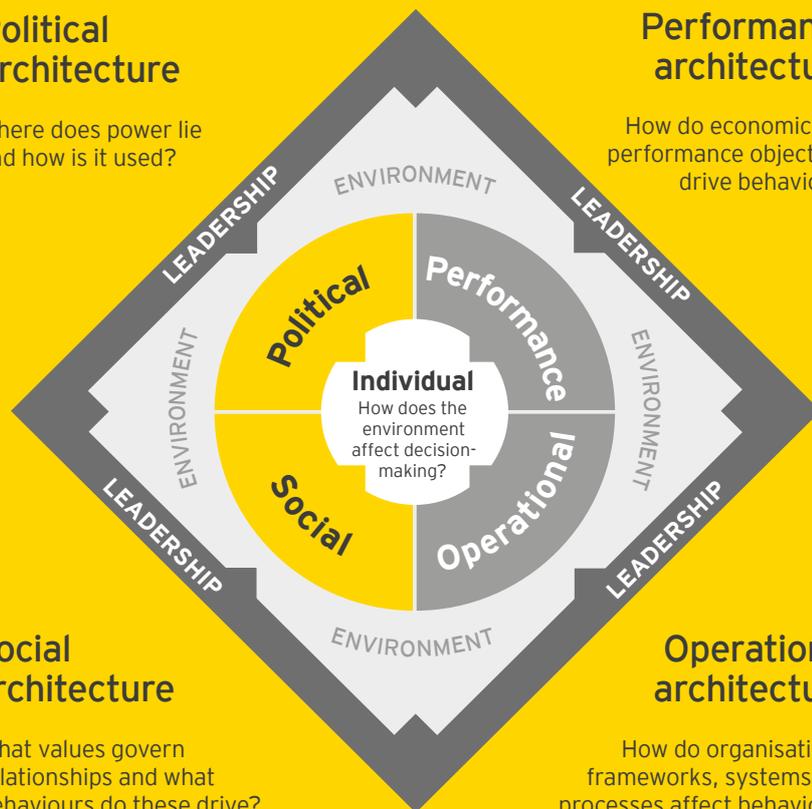
In line with EY's previous work, we define culture as the collective values and beliefs that exist in an organisation, or parts of an organisation, that inform and influence behaviours, actions and decision making. We believe culture is shaped by four organisational pillars:

### Political architecture

Where does power lie and how is it used?

### Performance architecture

How do economic and performance objectives drive behaviour?



### Social architecture

What values govern relationships and what behaviours do these drive?

### Operational architecture

How do organisational frameworks, systems and processes affect behaviour?



# Board-level vision for culture

Throughout a company, culture has a significant impact on employee decision-making and behaviours, risk management and, ultimately, performance.

Given that the board of directors is accountable for everything the company does or does not do, the board should have oversight of the overall culture of the company as well as an understanding of its sub-cultures.

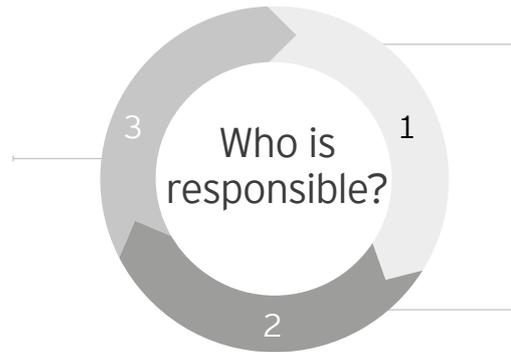
Evidence suggests boards could be doing more. In a recent survey of FTSE 350 board members conducted by EY and the FT<sup>1</sup>, the majority of respondents believed that their board should take greater responsibility for shaping and monitoring culture. In addition, although 86% of respondents felt that culture was fundamental or very important to overall strategy and performance,

only 19% say the board is currently primarily accountable for culture.

The board has an important role in relation to the political, social, performance and operational architecture that shapes culture. This begins with creating the vision for the desired culture within the organisation. Responsibility for bringing that vision to life and embedding it within operations or sometimes driving change falls to management, but the board must then apply rigorous methods for assessing, monitoring and overseeing culture.

<sup>1</sup> EY, *Is your board yet to realise the true value of culture?*, 2016.

Responsibility circles back to the board to apply rigorous methods for monitoring and oversight.



The board role in culture begins with creating the vision for the desired culture within the organisation.

Responsibility for bringing that vision to life and embedding it within operations falls to management.

## Questions on culture for board reflection:



**86%**

of respondents say culture is fundamental or very important to strategy.

Source: EY, *Is your board yet to realise the true value of culture?*, 2016.

Given the importance of culture to strategy and performance, is your board's deliberation and focus on culture adequate and appropriate?

## Agenda

**Q** 1. How comprehensively and specifically has the board discussed the importance of culture and defined the culture it wishes to instil throughout the company? How effectively are sub-cultures throughout the company tied together by well-articulated values?

2. How does culture appear on the board agenda? Is it a specific agenda item that features, for example, once a year or is it considered in a more embedded way throughout all board discussions and decisions?

3. How much consideration has the board given to the extent to which the business model and/or strategy relies on culture? How could the wrong culture threaten the business model or delivery of the strategy?

4. If the board believes the competitive advantage of the company is reliant on any particular behaviours in the company, for example, ongoing innovation, does the current culture support those behaviours?

5. How clearly has the board defined the company's risk appetite? How has it ensured that this risk appetite is understood at all levels in the company and that decisions are made in line with it? Does the risk appetite of the board match the real risk appetite of the organisation?

## Board evaluations

**Q** 1. To what extent do internal and external board evaluations include insights on the culture of the board and the board's oversight of the company-wide culture? If board evaluations don't address these issues, how might they do so?

2. What is the board's attitude towards, and response to, board evaluations? Is the board committed to improving as much as possible or are evaluations seen as compliance exercises? To what extent does the board follow up on action points year-on-year and explain to shareholders how they have done so?

3. Would the board consider inviting comments from those within the company who have access to the board (but do not sit on the board) to get an 'outside in' view of the board's culture?

## Board dynamics

- Q** 1. What is the power dynamic within the board between non-executive directors (NEDs) and executive directors (EDs) and between the whole board and the CEO? How do these dynamics affect delegation, accountability and collaboration?
2. How effectively does the Chairman foster diversity of thought on the board and how does this influence values and behaviours in the rest of the company?
3. How does the board's relationship with the CEO influence the culture that the CEO instils throughout the management team and further down in the company? For example, what incentives or constraints does the board put on the CEO that the CEO may filter down to other employees?



47%

*of respondents say there is a little or partial consensus at board level on what company culture should be.*

Source: EY, *Is your board yet to realise the true value of culture?*, 2016.

Ensuring there is board consensus on the desired culture in the company is an important first step before being able to effectively monitor that culture.

## Monitoring performance

- Q** 1. What active, measurable steps is the board taking to ensure that the values it wishes to instil throughout the company are consistent with those actually being lived and experienced by people on the ground?
2. How has the board considered specific metrics that could be measured and monitored as a barometer for culture or cultural risk? These could include customer and employee satisfaction, absentee rates and retention rates.
3. How does the board take into account the potential cultural context underlying KPI results? For example, if all KPIs are very positive, or possibly above target, over an extended period of time, does the board ask why? Does the board examine any potential cultural pressures that may be present to artificially 'keep up' certain metrics or KPIs and, if so, consider any related risks?
4. When things are going well, how often does the board ask for information from management on what has not gone to plan? Is this done in a spirit of seeking transparency and oversight or to place blame?
5. What mechanisms does the board use to assess cultural fit and integration when considering new or recent acquisitions? For recently completed acquisitions, what is done to understand the culture or sub-cultures and if necessary align them?
6. What level of detail does the board obtain on survey results and hotline calls? Does this include the nature of employee, customer and supplier complaints and actions taken in response?
7. To what extent does the board understand how whistle-blowers are regarded and treated within the company?
8. Has the board gained sufficient assurance on the accessibility of hotlines and whistle-blowing procedures?

## Accountability

- Q** 1. Does the board have a track record of being open and transparent with shareholders and other stakeholders? If not, why not?
2. To what extent is the board proactive in its shareholder communications or does it just disclose the bare minimum? If it is passive, why is this?
3. How does the board seek feedback from shareholders and other stakeholders, including employees, on the culture they would like to see, their perception of the current culture within the organisation and any concerns they may have? How is this feedback used?

# Key messages for board consideration:

When everything is going well, boards still need to assess the organisation's political, social and other architectures and ask why performance is good. This can either be to understand whether there are any pressures to keep results up or indeed to understand how high-performing teams are achieving their results and replicate positive examples throughout the organisation.

The board is responsible for defining the desired culture, delegating the embedding of culture in operations to management, and then overseeing and monitoring the result.

The board should review how it will assess and monitor corporate culture in a rigorous manner. While there is no single measure for culture, relevant proxy indicators include employee turnover, absenteeism due to illness and customer satisfaction results. Cultural assessments can also be undertaken, either internally or by an independent third party.

Boards should seek high quality feedback from as many sources as possible, and at different layers in the organisation, on the current culture. They should also welcome input from shareholders on the culture they would like to see within the company and communicate with shareholders about the current culture. If there is insufficient communication on this topic directly from the company, shareholders will find other ways to assess culture.

The board should reflect on its internal power dynamics and how they affect culture within the board as well as the 'tone from the top'. The board should also consider how board culture affects communication and relationships with stakeholders.

The board should consider whether the misalignment of desired and actual values and behaviours can represent a risk to the achievement of the organisation's goals and seek assurance that adequate monitoring is in place to enable the board to identify and react to cultural issues in real time.



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## Nomination committee

The nomination committee's role is important because it ensures the long-term succession of the leadership of the company.

Increasingly we have also heard that it plays a role in the oversight of executive talent pipeline below board level. The committee's significance was highlighted in EY's recent report *The nomination committee - coming out of the shadows* (May 2016), which shows the varying ways that nomination committees work in practice.

In all cases, however, leadership is a key determinant of culture and the nomination committee plays a vital role in attracting and hiring leaders who will instil and exemplify the desired culture, or bring about a much-needed change. It also needs to ensure that the leadership team contains sufficient diversity to enable sound decision-making.

# Questions on culture for nomination committee reflection:

## Recruitment

- Q** 1. How does the nomination committee consider culture and values when hiring executives and non-executives? Does it consciously assess whether candidates align with the desired culture? Alternatively, does the recruitment process assess whether candidates can bring about positive cultural change?
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2. When considering external candidates for key executive roles such as that of the CEO, how does the nomination committee gain insight into their previous organisations' cultures in order to assess their likely impact?
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3. How effectively do job and role descriptions explain and reflect the desired culture within the company?
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4. If a search firm is used for recruitment, how well does it understand the committee's cultural priorities and ensure that potential candidates fit with those priorities?
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5. How effectively do NEDs lead by example in demonstrating the desired culture? To what extent is the importance of this considered in the recruitment process for NEDs?
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6. To the extent that the nomination committee has a role in overseeing senior executive talent management, how much insight does the committee have on how senior individuals 'live' the culture and values? If there are any issues, how do these impact an individual's progression?

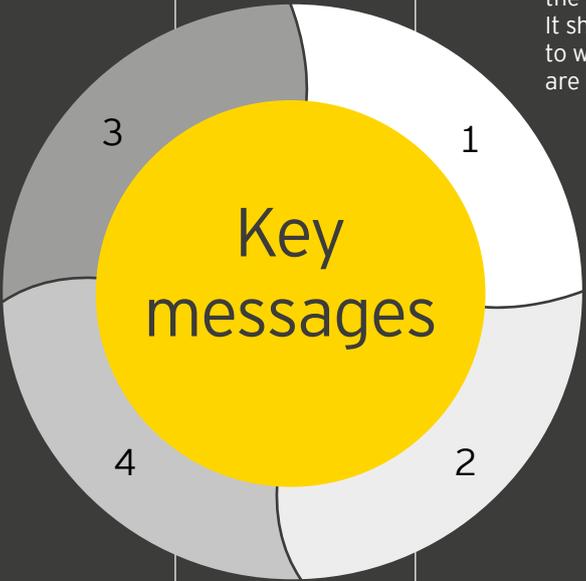
## Retention

- Q** 1. Has the committee considered whether training and development on culture and values throughout the company is required? If so, how is the effectiveness of the training tested to ensure that the culture and values continue to be understood throughout the company following the training?
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2. Is cultural training a one-off event or is it refreshed? Are cultural considerations embedded into all training programmes?
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3. To what extent does alignment with the desired culture impact promotions? Is the same approach applied across all employees?
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4. If a change in organisational behaviour is required, how might the committee's succession plan take into account the journey required to achieve the desired culture?
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5. Has the committee considered conducting external sentiment analysis, e.g., using external intelligence, such as employee review sites, to gauge any cultural issues in the company?

# Key messages for consideration by nomination committees:

Employees should be trained in how to use the company's stated values when making daily business decisions. The committee should gain assurance on the effectiveness of such training.

The nomination committee should consider the current and desired culture of the company when recruiting the CEO and NEDs to ensure that new appointments are aligned with the organisation's goals. It should also consider the extent to which external search firms are briefed on culture.



The nomination committee should consider gaining assurance that feedback on culture from departing employees as well as from external sentiment analysis is monitored and addressed.

The nomination committee should consider how it gains assurance on the integration of cultural considerations into recruitment practices within lower levels of the company as well.



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# Audit committee

The audit committee has a unique role to play in the governance of culture, which can directly affect the integrity of the financial statements, internal control processes and risk management.

The organisation's political, social and other architectures affect behaviours and decision making. They create the environment in which internal controls must operate. Misalignment between the desired and actual culture, and between desired and actual behaviours, has clear implications for risk management. As EY's

paper, *The route to risk reduction: better rules or better decisions?*, points out, using culture to enhance compliance frameworks, and thereby reduce risk, can lead to reductions in fines imposed and litigation costs, fewer financial misstatements and lower counterparty risk, including in supplier relationships.

# Questions on culture for audit committee reflection:

## Risk management

- Q** 1. How thoroughly has the committee discussed the impact of culture on risk, risk management and the internal control environment?
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2. Could the absence of the desired culture throughout the company be a risk in itself? In what ways would the company's performance be impacted by shifts in culture?
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3. How effective is the committee at challenging itself on an ongoing basis to get assurance that new risks and issues are identified as early as possible?
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4. How has the committee ensured that the culture instilled in the business supports risk mitigation strategies?

## Internal control

- Q** 1. How thoroughly does the committee consider potential underlying cultural issues when assessing the effectiveness of internal controls? For example, where a control failure is found, are cultural issues examined as part of the root cause analysis?
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2. How are the power of data analytics and other new technologies being harnessed to create a composite picture of the culture throughout the company? How is this analysis used to inform the audit committee's assurance role e.g., in directing internal audit's scope?
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3. How effective is the committee in creating an environment that encourages individuals to share and solve internal control problems rather than ignoring them? What is the organisation's attitude to people who highlight issues and problems?
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4. To what extent does the committee have oversight of whistle-blowing/employee hotline calls and how whistle-blowers are treated?
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5. Does the committee get thorough and independent assurance/evidence of risk mitigation and controls to corroborate or supplement management information?
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6. What is the power dynamic between the audit committee and the CFO? And between internal audit and senior management?



**88%**

*of organisations are not currently providing detailed information on culture in their public filings/annual reports.*

Source: EY, *Is your board yet to realise the true value of culture?*, 2016.

In absence of public articulation of your culture, what are your investors using to assess your culture? Is there a risk that they fill this void using inappropriate or incorrect sources of information?

## Financial statements and reporting

- Q** 1. To what extent has the committee considered potential underlying cultural issues when assessing the integrity of financial statements e.g., unintended incentives for misreporting?
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2. Are there any cultural pressures throughout the company, or in certain parts of the company, that might increase the risk of financial misstatement due to fraud or error?
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3. Does the audit committee ask for analysis of how high performance is being achieved in order to obtain comfort that this is not due to overly risky behaviour?
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4. Does the company's reporting to the market accurately reflect the culture the board is trying to promote? Does the reporting give sufficient insight into the existing culture and the desired culture and how this is being embedded?

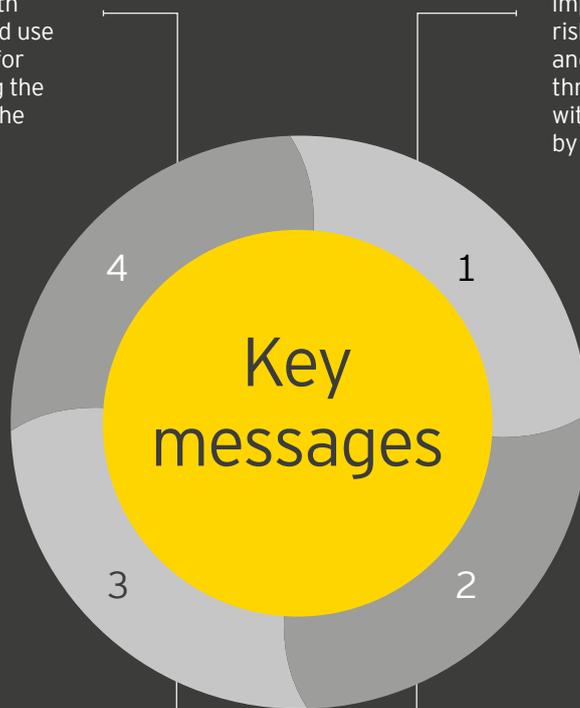
## Effectiveness of assurance processes including internal and external audit

- Q** 1. How aware is the committee of how its own culture affects the internal and/or external auditor's interactions with the audit committee and management?
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2. Has the committee considered whether senior management or other key influencers use formal or informal power to constrain the independence and effectiveness of the internal and external audit functions in raising issues?
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3. Does the committee ask for feedback about the company's culture from the external auditor? If so, what does it do with the feedback?
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4. Has the committee considered the role of internal audit in assessing culture?
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5. In overseeing and reviewing the scope of internal and external audit plans, e.g., geographic, functional, divisional etc., how are any cultural indicators of risk used to define and/or challenge the scope? For example, are there parts of the organisation that require greater focus due to high employee absenteeism or low employee engagement results? Are high-performing locations also included to assess whether that high performance is being achieved in a sustainable way in line with the board's risk appetite?

# Key messages for consideration by audit committees:

The committee should be aware of cultural factors that can influence the relationship with the external auditor. It should use internal audit as a resource for monitoring and championing the desired culture throughout the organisation.

The audit committee should understand how culture can impact the effectiveness of risk mitigation strategies and support decision making throughout the company in line with the risk appetite determined by the board.



Data analytics can help the committee create a picture of culture throughout the company, including across international locations. This data should form part of the overall analysis that is used to drive further assurance and oversight efforts.

The committee should consider the cultural context for performance and results and the integrity of the financial statements.

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## Remuneration committee

An organisation's remuneration philosophy and framework, in particular its incentives, have a substantial influence on behaviours and decision making. The remuneration committee should be aware of the current and potential consequences of the structure of remuneration packages. It should also consider the impact the committee's culture may have on the rest of the organisation.

# Questions on culture for remuneration committee reflection:

## Incentives and rewards

- Q** 1. How comprehensively has the board considered the range of potential consequences of remuneration structures on behaviours and decision making? Are remuneration structures too complex for the board to be able to anticipate resulting behaviours? If so, why aren't they simpler?
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2. Are reward schemes sufficiently long-term to incentivise a forward-looking culture? To what extent has the committee discussed how financial targets are likely to impact culture?
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3. Do the organisation's political, social and other architectures encourage or inhibit open discussions between executive management and the board about the appropriate level of stretch in financial targets?
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4. Has the committee considered including metrics for variable rewards that measure 'cultural improvement' e.g., progress on resolution of conduct issues, employee engagement issues, co-operation across divisions? Has the committee considered other ways to incentivise delivery of cultural change?
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5. To what extent, if any, has the committee created a culture in which year-on-year salary increases are expected, contributing to an upward ratchet?
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6. To what extent does the culture encourage an expectation that bonuses are effectively part of guaranteed pay? How can that culture be avoided without de-motivating executives?

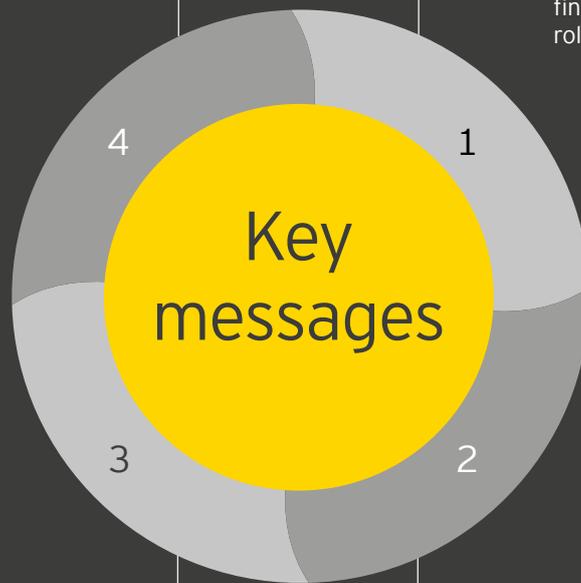
## Behaviours and oversight

- Q** 1. How does the committee compare and consider employee wide pay versus the pay of senior executives? How may employee perceptions of the gap impact their behaviours and decision-making?
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2. How does the cultural dynamic between the whole board and the CEO influence remuneration decisions?
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3. How often does the committee use upward discretion in determining awards and how might this affect attitudes and behaviours in senior executives and throughout the company?
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4. How does the committee deal with difficult decisions where, e.g., malus or clawback should be used?

# Key messages for consideration by remuneration committees:

Including cultural indicators in performance metrics can help to incentivise the CEO to embed desired political, social and other architectures throughout the organisation.

Remuneration is a key lever in influencing behaviours and decision making. However, relying solely on reward-based incentives to drive culture change could be regarded as counter-productive. Non-financial incentives also have a role to play.



The committee should consider how power dynamics influence its decisions and willingness to take difficult or unpopular decisions in relation to remuneration.

The remuneration committee should discuss how the current remuneration structure might impact behaviours and what changes might be required to align incentives with the desired behaviours.

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# Conclusion

The concept of culture poses many challenges from a governance perspective. It can be defined in different ways and is difficult to measure.

Nevertheless, principles of good governance can be applied.

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**In part, good governance is about boards continually asking the right questions of themselves and of management in order to gain assurance on the performance and behaviours of the business. The questions we suggest in this paper are intended to help boards and committees exercise their monitoring and oversight role in respect of culture and behaviours.**

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Effective monitoring of culture involves digging down through organisational layers to understand behaviours and decision making at all levels.

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**We believe that boards and board committees must embrace the governance challenge, applying a cultural lens to their roles and responsibilities.**

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Considering the organisational pillars that shape culture should be a natural part of board and committee activities. Culture affects behaviours and decision making. It directly affects risk management and ultimately business performance. It's therefore vital that boards and board committees include cultural considerations within their governance frameworks. Culture shouldn't just be a hot topic for discussion, but also for governance action.

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