



## STANDING ADVISORY GROUP MEETING

# <u>PANEL DISCUSSION – CORPORATE CULTURE: IMPLICATIONS FOR THE</u> AUDIT

**JUNE 5-6, 2018** 

#### INTRODUCTION

At the June 2018 Standing Advisory Group ("SAG") meeting, a panel will discuss corporate culture and its implications on the audit. After the panel's presentation, SAG members will have an opportunity for further discussion. This paper provides background information and outlines the topics that the panelists will address.

#### BACKGROUND

According to the Committee of Sponsoring Organizations ("COSO"), a company's culture supports its control environment insofar as it sets expectations of the behavior that reflects a commitment to integrity and ethical values, oversight, accountability, and performance evaluation. Establishing a strong culture considers, for example, how clearly and consistently ethical and behavioral standards are communicated and reinforced in practice. 2

Poor corporate culture can lead to problems in a company. For example, in one academic study, a survey of company executives found that 85% believe a poorly implemented, ineffective culture increases the chance that an employee might act unethically or even illegally.<sup>3</sup> Indeed, corporate culture has been cited as a contributing

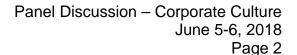
- Id.

This paper was developed by the staff of the Office of the Chief Auditor as of May 23, 2018 to foster discussion among the members of the Standing Advisory Group. It is not a statement of the Board; nor does it necessarily reflect the views of the Board, any individual Board member, or staff of the PCAOB.

<sup>&</sup>lt;sup>1</sup> COSO, Internal Control—Integrated Framework (2013).

<sup>&</sup>lt;sup>2</sup> *Id.* 

John R. Graham, Campbell R. Harvey, Jillian Grennan, and Shivaram Rajgopal, *Corporate Culture: Evidence from the Field* (Mar. 2017) (working paper, available in Social Science Research Network ("SSRN")). A separate 2015 academic study found when reviewing companies' web pages "that 85% of the [Standard and Poor's 500] companies have a section (sometimes even two) dedicated to — what they call —





factor in recent corporate scandals.<sup>4</sup> In addition, corporate culture may affect financial reporting risk at a company.<sup>5</sup>

Some corporate culture changes have occurred in response to changes in the legal and regulatory environments. For example, Section 301 of the Sarbanes-Oxley Act of 2002 ("Sarbanes Oxley") requires public company audit committees to establish procedures for the confidential, anonymous submission by employees of concerns regarding accounting or auditing matters. Also, many companies have adopted compliance and ethics programs designed to assure compliance with applicable legal requirements.

Corporate culture is a major focus area of some corporate boards and audit committees. A recent survey of audit committee members found that tone at the top and the culture of the organization was one of the top issues that pose the greatest challenges to companies. The survey further noted that "[t]one at the top, culture, and short-termism are major challenges—and may need more attention." In addition, the

'corporate culture,' i.e. principles and values that should inform the behavior of all the firms' employees." See Luigi Guiso, Paola Sapienza, and Luigi Zingales, *The Value of Corporate Culture*, 117 Journal of Financial Economics 60 (2015), at 61.

- See, e.g., Geoff Colvin, Inside Wells Fargo's Plan to Fix Its Culture Post-Scandal, Fortune, June 11, 2017; Charles M. Elson, Craig Ferrere, and Nicholas J. Goossen, The Bug at Volkswagen: Lessons in Co-Determination, Ownership, and Board Structure, 27 Journal of Applied Corporate Finance 36 (2015); and Andreas Cremer, CEO Says Changing VW Culture Proving Tougher Than Expected, Reuters, May 22, 2017.
- <sup>5</sup> See, e.g., Yuan Ji, Oded Rozenbaum, and Kyle T. Welch, *Corporate Culture and Financial Reporting Risk: Looking Through the Glassdoor* (June 1, 2017) (working paper, available in SSRN).
- See Section 301 of Sarbanes Oxley, codified in Section 10A(m)(4) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. 78i-1(m)(4).
- <sup>7</sup> See, e.g., Tapestry Networks, Inc., *ViewPoints For the Audit Committee Leadership Summit* (July 13, 2015), at 2 ("Corporate culture is becoming a major area of concern among boards and audit committees.").
- See KPMG, Is Everything Under Control? Audit Committee Challenges and Priorities, 2017 Global Audit Committee Pulse Survey (2017).
- <sup>9</sup> *Id*. at 8.





National Association of Corporate Directors ("NACD") recently released a report that explores how boards can strengthen their oversight of corporate culture. 10

## **AUDITOR RESPONSIBILITIES**

Under PCAOB standards, the auditor is required to obtain an understanding of the company and its environment to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement.<sup>11</sup>

Additionally, as part of obtaining an understanding of internal control over financial reporting, the auditor is required to obtain an understanding of the company's control environment, including the policies and actions of management, the board, and the audit committee concerning the company's control environment. This includes assessing whether:

- Management's philosophy and operating style promote effective internal control over financial reporting;
- Sound integrity and ethical values, particularly of top management, are developed and understood; and
- The board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.<sup>12</sup>

### PANELISTS' PRESENTATION TOPICS

A panel of SAG members will discuss corporate culture, including its implications on the audit. The panel will consist of:

 An audit committee member, who will discuss the importance of corporate culture and how companies are approaching corporate culture issues;

See NACD Blue Ribbon Commission, *Culture as a Corporate Asset* (Oct. 4, 2017).

See paragraph .07 of AS 2110, *Identifying and Assessing Risks of Material Misstatement.* 

<sup>&</sup>lt;sup>12</sup> See AS 2110.23-.24.





- A corporate governance expert, who will discuss how boards are considering corporate culture and the potential impacts of corporate culture issues on financial reporting;
- An investor, who will discuss investor views regarding corporate culture, such as how corporate culture influences investment decisions; and
- An auditor, who will discuss auditor considerations related to corporate culture, for example, as it relates to obtaining an understanding of the company and its environment.

SAG members will have the opportunity to discuss the topic and share their views on corporate culture and potential implications to the audit.

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