STUDIO ETICA
Compliance & Ethics Consultancy

Auditing Culture, Assessing Behavioral Risk: A Practical Guide

WHITEPAPER

Our Approach to Behavioral Risk Management

The challenge

When the FSGO were amended in 2004, the notion of ethics was added to the definition of an 'effective program.' Since then, regulators worldwide have begun to emphasize the role of ethics in preventing and detecting criminal conduct. In addition to having compliance standards and procedures, organizations are expected to ‘otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law’[1].

By doing so, the regulators aimed to look outside the traditional law enforcement toolkit - insufficient for the complex challenge of dealing with human behavior.

Whatever industry you're in, addressing ethics is likely a prerequisite for your ethics & compliance (E&C) program to qualify as effective for regulators.

Developing a program to evaluate and monitor ethical risks is challenging yet not insurmountable. And this is where behavioral science can be helpful.

The Concept of Behavioral Risk

A first important lesson from behavioral ethics stems from the idea that perfect rationality, which forms the basis of many classical economic theories, is not an accurate description of how people make their decisions. Behavioral economics is a body of psychology that shows that we are not as rational as we think. Behavioral ethics, a subset of behavioral economics, apply that lesson to ethics.

The essential mission of effective E&C programs—to create a management system to prevent violations of law and ethics— is best served when compliance officers broaden their focus to organizational behavior and culture, enhancing their approach to risk management.

Human behavior is a way of achieving a goal. Those behaviors, which, as we feel, are more effective in achieving our goals, become behavioral patterns, i.e., actions performed automatically. When asked about the drivers of such behaviors, people are likely to say, 'this is how things are done here,” which is also a popular definition of organizational culture.

A simple sequence illustrates the point: drivers lead to behaviors, and these, in turn, lead to outcomes.

In this framework, the behavioral risk is a risk of unwanted behavior leading to poor decisions or outcomes for the organization and the stakeholders.

Although the behavior is the part we see, we need to focus on the drivers that shape it rather than the behavior itself to change it. These are also called behavioral risk factors.

Behaviors do not exist in a vacuum – they arise from many drivers' interactions. They are strongly influenced by the surrounding social context and, more specifically, by the groups a person belongs to or identifies herself with.

Kurt Lewin introduced a formula B = f (P, E) that illustrates how an individual's behavior is a function of the person **and** her environment [2]. This environment, and the corresponding drivers, can exist on three levels: the team (leadership style, performance targets), the organization (company policies, strategies), and the broader context outside the organization (local culture, the rule of law).

To change behavior means to change the environment in which one operates.

Following that thinking, managing behavioral risk is not about assessing individuals and their characteristics but rather about looking into group habits and norms that might need changing. It's about looking into the organizational culture and 'how things are done here.

Why Internal Audit

There is an increasing trend from regulators worldwide to expect internal audit activity to assess organizational culture. For example, in the UK, Singapore, and Australia, the financial authorities require internal auditors to evaluate and comment on behaviors and culture [3].

Indeed, the International Standards for the Professional Practice of Internal Auditing (the IIA standards) clearly state that the internal audit plan must be risk-based [4]. This implies that internal audit activities should consider what behavioral or cultural issues pose a risk to the organization and what behavioral or cultural factors could undermine how risk is managed in relation to managing a specific key risk.

Following that thinking, major financial institutions – pioneers in applying a behavioral lens to risk management – have set up their Behavioral Risk Management (BRM) departments within the remit of Internal Audit/Risk functions, reporting directly to Chief Audit Executive or Chief Risk Officer.

A typical approach to managing behavioral risks is similar to the one used for any other types of risk; at a high level, there are three major stages involved:

1. Identify focus areas prone to behavioral risks
2. Assess behaviors and their underlying drivers by collecting and analyzing the relevant data
3. Mitigate the identified risks by changing undesired behaviors with the right interventions

Identifying Risk-Prone Areas

Selecting business areas to be assessed for behavioral risks is the essential first step to getting you started with the BRM work. Defining risk-prone areas involves considering four major groups of factors:

- Risk-driven triggers ('push'), based on internal audit leadership and board consultation or other stakeholders' request, includes looking at strategic priorities and underperforming areas.
- Event-driven triggers ('pull') based on incoming signals or in response to management's requests.
- Internal Audit's view: observations from prior audits, professional judgment, data extraction from internal IT systems, HR surveys, or relevant self-assessments.
- Administrative considerations for the internal audit leadership team to decide, including resourcing and time, capability building required, and how BRM engagements can be best integrated into the annual audit plan.

Selecting a Reference Model

How would you determine whether your organization's culture is ethical? You need a clear, robust set of criteria against which you can judge behavioral or cultural risks. A reference model, in other words.

There are many models available. When choosing among them, consider the model's validity – whether the evidence base and peer review have confirmed it. Independent regulatory agencies and industry bodies can be a valuable source of guidance for selecting a suitable model and essential factors that should be included in it. Arguably, the best model for an organization is the one that finds the weaknesses to promote and track improvement.

Behavioral Risk Factors

Organizational culture has a complex structure at both tangible and intangible levels, with underlying formal and informal behavioral drivers. Regardless of the model you choose, the best practice approach identifies the following behavioral risk factors (or drivers) that you should aim to cover:

- Formal aspects of culture
- Informal aspects of culture
- Leadership behaviors

Formal aspects

The formal aspects of the organization's culture are structural and include written policies and procedures, organizational charts, HR practices, job descriptions, hierarchical lines, and incentive systems. In other words, these are the tangible elements that describe how the organization looks and works on paper.

Formal communication cascaded from top to bottom also provides insight into organizational priorities and affects the organization's performance. The official announcements, CEO messages, and town hall meetings fall under this category.

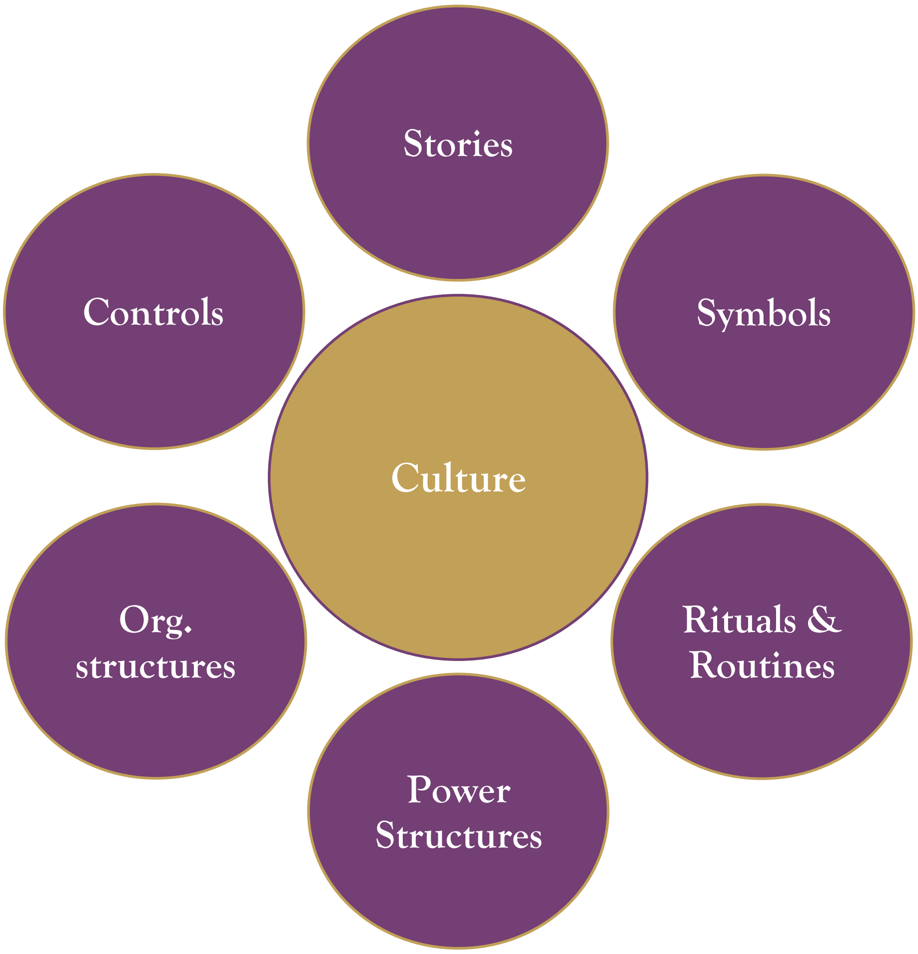
How goals are set affects people's behavior; therefore, a company's goal-setting and incentives structure probably offers the best indicator of whether compliance is taken seriously. Unrealistic targets and belief in growth at all costs foster an environment of high pressure and stress which may result in unwanted behaviors and impede the organization's ethical performance. Work pressure, employee rewards, benefits, and compensations and how fair these are perceived offer a key insight into the levels of existing behavioral risk.

Informal Aspects

The informal aspects refer to the intangible side of the organization, which includes the unwritten rules that guide everyday behaviors and how the individual and collective perceive the formal drivers of culture. Shared values and beliefs, rationalizations, and underlying assumptions – all of these are often overlooked. However, understanding how people work together in practice, not on paper, is critical for effective risk management.

A model called "The Culture Web" showing a paradigm of the working environment is often used to illustrate the informal elements of culture.

Exhibit 1. Johnson and Scholes Cultural Web



Stories include events, and people discussed internally, and how employees perceive this information.

Symbols are tangible and intangible representations of the organization, like the company's logo, dress code, or office layout.

Rituals & Routines represent employees' everyday behaviors.

Power structures describe who and how makes the decisions in the organization.

Organizational structures include org charts, roles, responsibilities, and communication flows.

Culture is a paradigm by which every other aspect of the cultural web is viewed.

Leadership behaviors

Finally, leadership is central in creating the right working environment to drive employee performance. It is key for leaders to understand the impact of their own behavior on employee decision-making and adjust it accordingly when it drives behavioral risk. Through their actions, inaction, choices, decision, and the behaviors they reward, discipline, or ignore, leaders, provide their followers with powerful messages on what is really valued and what is required to survive and succeed in an organization.

Developing Behavioral Anchors

Following the behavioral risk factors and the dimensions of the reference model you have chosen, you will need to develop a set of specific statements (sometimes referred to by social scientists as 'behavioral anchors') that describe desirable versus undesirable behaviors. Behavioral anchors are a key tool for conducting a behavioral assessment. These statements provide transparency and alignment of objectives between the internal audit, auditees, and other stakeholders. It also reduces unconscious bias in an auditor's observations by providing a common reference point.

Most organizations have existing documentation that may reference the risk management behavior expected of staff and managers/leaders. These can be valuable sources when defining behavioral anchors. It may also be helpful to gather suggestions from leadership and other stakeholders. Socializing the draft statements with subject matter experts helps ensure everyone is aligned on expectations.

Exhibit 2. Sample Behavioral Anchors

Behavior	Unacceptable	Acceptable	Desirable
Reporting ethical concerns and risk events	Employees conceal ethical concerns, risk events, and mistakes	Employees report ethical concerns, risk events, and mistakes with an adequate level of detail	Employees report ethical concerns, risk events, and mistakes thoroughly and in a timely manner

Defining the Scope and Methods

Managing culture is not about changing specific cultural levels in isolation but about achieving alignment throughout. Misaligned cultures are dangerous as they cause cynic attitudes and distrust in management and may ultimately lead to unwanted behaviors [5].

Behavioral scientists use multiple methods to look at tangible and intangible elements (e.g., desk research to look at written rules and ethnographies to observe the behavior in real-life situations). Mixed methods provide better insight, reveal any misalignment between the elements, and help minimize the inherent limitations of every single method [6].

A wide range of data collection and analysis techniques can be applied when auditing organizational culture. The overarching method you choose will help guide these choices:

1. Surface-level behavioral risk assessment.
2. Subculture deep dive audits.
3. Comprehensive audit program that combines methods 1 and 2.

Surface-level behavioral risk assessment indicates behavioral risk across the organization. Possible tools include culture and engagement surveys and behavioral observation as part of the regular audit program. Although surveys are valuable instruments, they may be insufficient to have a good insight into the culture. Many behavioral risks are not related to what you can measure with a survey.

As ethical culture worsens, surveys become less reliable due to pressures and the normalization of poor behavior. Also, surveys are affected by the subcultures people answering them are embedded in. In environments with low psychological safety, employees won't speak up for fear of repercussions, or unethical behavior may be so normalized that employees might not see any problems at all. Either way, nothing will come up in a survey.

That said, surveys help generalize observations to larger populations, but it is essential to remember that a survey is a data set that needs to be understood within other data sets. In other words, surveys are not truth.

Subculture deep dive audits seek to form a thorough assessment of culture in a particular subgroup, looking into all elements, from outcomes to behavioral norms and their systemic root causes.

Culture typically forms in groups of people that have regular interaction, often with a common manager [7]. In large organizations, the climate can vary significantly from one team/location/department. Therefore, it is incorrect to assume that culture is consistent throughout an organization or even within a large division, function, or tier of management.

When a specific behavior needs to be changed, it is critical to be very specific. The same applies to managing culture: a very targeted approach can be more beneficial than looking at the whole organization with a holistic culture assessment. Because problems usually lie in the granular but not in the average.

Possible tools for this method include ethnographies, an immersive approach associated with work-floor observations, and semi-structured interviews and confidential conversations.

A comprehensive audit program combines the two approaches but offers more than the sum of the two parts. This method is usually selected by organizations where culture is a strategic priority.

Analyzing and Reporting Data

Whatever approach you choose, it is key to remember that every single assessment method has inherent limitations – to compensate for that, use a mix. The academics call it a 'mixed method' approach. In practice, this means using quantitative and qualitative methods, which allows for exploring diverse perspectives and uncovering relationships between layers and elements of culture.

Before drawing any conclusions, all quantitative and qualitative inputs should be analyzed and triangulated to see if any common themes come up. The aim is to test for consistency. These should then be connected to behavioral theory to arrive at evidence-based red flags and recommendations to management.

There are several options to communicate the results of the behavioral risk assessment. Formal written reports are not necessarily the best way to share observations. Other tools may be more suited for the task, including culture dashboards, holding up the mirror workshops, or internal audit opinion papers. Before formally distributing the results, it is helpful to socialize the outcomes with subject matter experts and senior leaders knowledgeable of the scope but not directly involved to allow for an objective feedback loop.

After the results are communicated to the senior leadership team, the behavioral risk assessment is completed. It's time to start crafting interventions!

Endnotes

[1] US Sentencing Commission, The Federal Sentencing Guidelines (2018). Chapter 8, Section B2.1
[2] Lewin, K. (1951). Field theory in social science. Harper, New York.
[3] Arzadon E., Du Preez R., and Sheedy E. (2021). Auditing Risk Culture: A Practical Guide. The Institute of Internal Auditors, Australia, p.8.
[4] International Standards for the Professional Practice of Internal Auditing (2022). The Institute of Internal Auditors, Standard 10.
[5] van Rooij B. and Fine A. (2018). Toxic Corporate Culture: Assessing Organizational Processes of Deviancy. Administrative Sciences 8, no. 3, p. 23. https://doi.org/10.3390/admsci8030023
[6] van Rooij B. and Rorie M. (2021). Measuring Compliance: The Challenges in Assessing and Understanding the Interaction between Law and Organizational Misconduct. Available at SSRN: https://ssrn.com/abstract=3853764
[7] Arzadon E., Du Preez R., and Sheedy E. (2021). Auditing Risk Culture: A Practical Guide. The Institute of Internal Auditors, Australia, p.6.

About Studio Etica

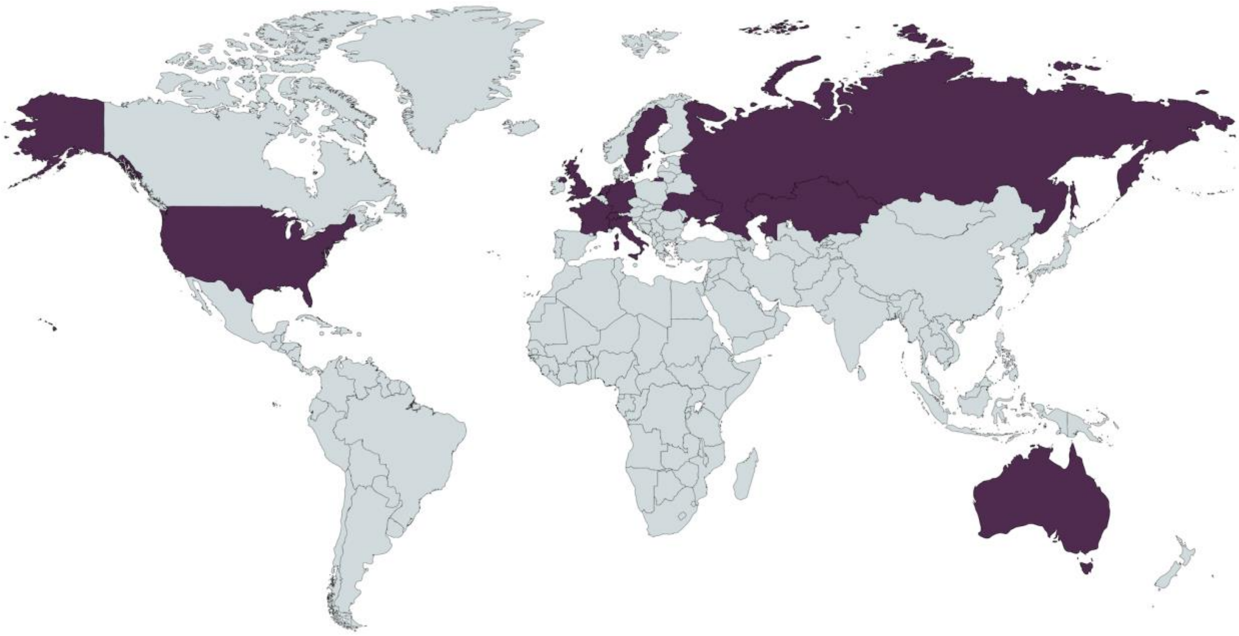
Studio Etica is a boutique consultancy that provides advice on corporate ethics and compliance programs to companies worldwide. We are dedicated to working with our clients to design, maintain and optimize world-class programs with a focus on a strong, values-based culture. **Studio Etica** focuses on helping organizations achieve cultural transformations that not only drive legal compliance but lead to enhanced integrity and positive behavioral change. We are convinced that ethical culture is central to a meaningful compliance program that delivers actual results.

About the Author

Vera Cherepanova, a former Regional Compliance Officer and author of "Compliance Program of Organization," is the founder of **Studio Etica**. Vera's background includes working on the ground in Eastern Europe, CIS, and Russia, one of the key emerging markets. Taking her experience in addressing cross-cultural challenges of ethics and compliance, Vera currently consults with international corporations, non-profits, wholesale and retail establishments, and small-to-large businesses, advising them on E&C programs.

Vera is an experienced speaker in the compliance profession and a regular contributor to prominent ethics & compliance blogs, including FCPA Blog, Corporate Compliance Insights, and SCCE Compliance & Ethics Blog. An accomplished compliance professional, in 2011 and 2016 awarded "Best Compliance officer" at the International Compliance Association in Compliance Awards. Vera speaks Russian, English, French, and Italian.

Where we have worked



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+39 (0) 3661553963 info@studioetica.com www.studioetica.com

