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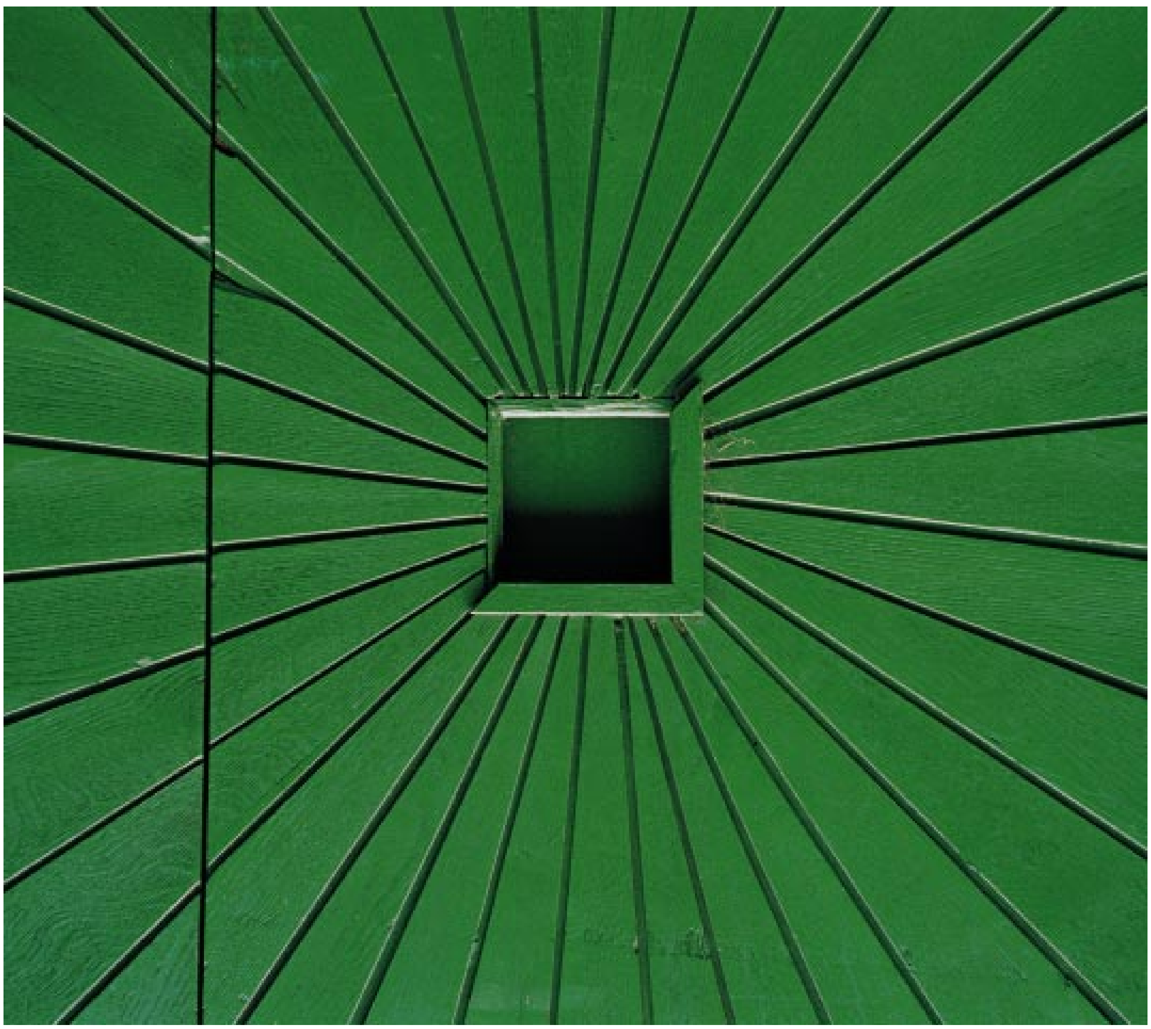

By Christopher Michaelson, Ph.D.

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What is Effective Compliance?

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Economic uncertainty can pressure a company to inflate its earnings, engage in questionable or unethical sales tactics, and otherwise manipulate the expectations of analysts, creditors, investors, customers, and other corporate stakeholders. But, countering such short-sighted activities and preserving a company's long-term objectives requires more than good intentions and the threat of an audit—it requires an effective compliance programme.

But what, precisely, is an "effective" compliance programme? And how does one create and maintain such a function? In this, the fourth in a series on the changing nature of corporate compliance, Christopher Michaelson offers some practice-proven advice on how to create a state-of-the-art programme.

Compliance programmes in the United States generally take the Federal Sentencing Guidelines (FSG) for Organizations as their starting point. The FSG, first introduced in 1991, provide seven due diligence criteria for managing a company's ethics and compliance risks. They are flexible enough to be tailored to the risk management structures of most companies. But what constitutes "effective" compliance on a paper checklist is distant from effective compliance in practice.

"Checklist" Compliance

The seven criteria for an "effective" compliance programme are:

1. Compliance standards and procedures

2. High-level officer

3. Due care in delegating authority

4. Effective communication

5. Monitoring/auditing/reporting

6. Consistent discipline

7. Process modification.

> THE FACT IS THAT MOST ORGANIZATIONS IN CRISIS ARE FORCED INTO [A] REACTIVE MODE PRECISELY BECAUSE THEY DO NOT HAVE A WELL THOUGHT-OUT APPROACH TO COMPLIANCE.

As with any good management control process, the FSG tell a seemingly common sense story about how to get things done: Someone in authority must be in charge, and willing to enforce expectations. What's more, those expectations must be properly documented and effectively communicated to, and understood by, those who need to observe them.

Companies should be especially wary of assigning responsibility to individuals with a known propensity for ignoring requirements. They should proactively monitor business conduct while keeping an ear open for reports of failure. Finally, such programmes should be continuously monitored—both to improve performance and to prevent possible failures.

The "checklist" response to the FSG typically includes such steps as:

- Choosing a Chief Compliance Officer—usually from an already overburdened management team
- Writing compliance policies and procedures
- Using background checks
- Delivering occasional compliance training
- Implementing compliance certification and a establishing a telephone hotline
- Developing disciplinary guidelines.

An organization with an effective compliance programme can use the FSG as a negotiating tool to reduce its "culpability score," which potentially can significantly reduce fines and penalties. The partial checklist above contains some positive steps toward enhancing organisational compliance, but those steps are not by themselves effective.

SOME INCENTIVE STRUCTURES PRESSURE EMPLOYEES TO ENGAGE IN MISCONDUCT.

Inevitably, when something does go wrong, a common response is to fire, or reassign, those directly responsible and introduce generic or hastily conceived training regimens for those who survived the "house cleaning." The question is, then, why does instituting a "checklist" FSG programme without broader justification often result in compliance failure?

The fact is that most organisations in crisis are forced into such reactive modes precisely because they do not have a well-thought-out approach to compliance. Compliance is seen as something separate from the core purpose of the business—a hurdle, or a distraction from everyday business. Compliance is seen as a necessary evil that only surfaces when a crisis arises, or change is forced on the company.

Effective Compliance

Creating a compliance programme that is a vital, value-added part of a business is a major challenge, but certainly attainable. Consider the following examples:

- A diversified service provider and product manufacturer was regularly in the news for its illegal dealings with restricted governments. Penalties levied by the U.S. government on the company were enormous, and the damage to the company's reputation was considerable. However, the organisation took this high-profile compliance failure and turned it to its advantage.

  Using the unwelcome media attention to maximum effect, it made a high-profile commitment to changing company ways of doing business. It would go from being the worst to the best in its class. Today, the company's commitment to integrity and adherence to compliance standards has rescued its reputation, and its compliance programme is regarded as a benchmark for competitors.

- Realizing that purely legal and technical compliance was not enough to address stakeholder concerns about the environmental impact of its business activity, a global energy company turned its compliance "liabilities" into business opportunities. It determined that in order to create long-term economic value, including long-term shareholder value, it would have to balance its business objectives along three dimensions of corporate social responsibility: economic, social and environmental.

  Today, the company is regarded as a leader in "sustainable" business practice, working actively with stakeholder groups to establish multidimensional performance measures, and then verifying and publicly reporting results.

Assembling a cross-functional compliance committee is one way of matching compliance requirements with the appropriate company function.

Thinking Outside the "Checklist Box"

Creating a broad-based, proactive compliance programme that is fully integrated into a company's business is complex, but ultimately much more effective than "checklist" compliance. To create an effective compliance programme, a company must ask, and effectively answer, a number of key questions, such as:

Is management support for compliance evident in its values, as they are stated and practiced?

Sometimes it takes a failure to alert senior management to the dangers of compliance failure. Some executives are genuinely committed to preserving corporate integrity, yet create and support incentive structures that pressure employees to engage in misconduct.

To be truly supportive, senior management should talk openly about the importance of compliance to the business and its reputation, set a positive example through their own behaviour, and fairly enforce penalties wherever misconduct occurs.

By the same token, a supportive board and audit committee will readily—and publicly—acknowledge their compliance oversight responsibilities by requiring management to give a periodic account of the company's compliance activities, and digging deeper when they are not satisfied with the answers.

Is there cross-functional support for compliance? Is it put into action through effective project management?

While a strong compliance programme has to begin at the top—and possess a certain degree of centralization in order to set consistent, enterprise-wide expectations—technical compliance obligations often vary by function.

Research and Development, for example, may be chiefly concerned about product safety; Sales, by comparison, typically possesses more than its fair share of compliance risks, often associated with gifts and entertainment and accounting practices.

And everyone is affected by the damage that can be done—to both corporate reputation and individual employees—if sexual harassment becomes a problem.

Assembling a cross-functional compliance committee is one way of matching compliance requirements with the appropriate company function, as well as ensuring that compliance is "built into" the organizational culture as a whole. Unfortunately, committees have an uncanny way of encouraging inaction, which is why any effective compliance committee must possess an effective project manager to put ideas into action.

ALTHOUGH SOME COMPANIES OFFER SPOT BONUSES FOR "EXTRAORDINARY" ETHICAL CONDUCT, IT IS COUNTERPRODUCTIVE TO REWARD PEOPLE FOR DOING WHAT THEY OUGHT TO BE DOING ANYWAY.

Is the approach to compliance firmly rooted in consistent ethical values?

One U.S. company's well-regarded code of conduct is entitled "The Spirit and the Letter," a clear mandate to observe the rules, both literally and in intent. Only by instilling a culture that guides ethical decision-making can a company properly position itself to take advantage of the new opportunities that arise in a constantly changing business landscape.

Does the compliance programme utilise technology effectively?

Computer-based training (CBT) is currently popular because it is able to reach a broad audience inexpensively. But not every employee, in every organization, has access to a computer (a seemingly obvious point that is often overlooked or dealt with by providing inferior, "bulletin board training" to shop floor employees.)

CBT can be very effective when it is used in conjunction with interactive training and communication methods. Other effective uses of technology include measuring and/or tracking employee certifications, well-organized training events, performance testing, incident management, and trend analysis, to name a few.

Is there a balance of rewards for promoting compliance and consequences for misconduct or disengagement?
Although some companies offer spot bonuses for “extraordinary” ethical conduct (e.g., reporting a manufacturing defect that could be responsible for greater losses down the line) it is counterproductive to reward people for doing what they ought to be doing anyway.

Equally problematic is the practice of rewarding people in ways that promote non-compliance (e.g., focusing on revenue as the only measure of performance in incentive compensation), or selectively enforcing compliance (i.e., “going easy” on perceived “rainmakers”).

The effective integration of a compliance function into performance evaluations should be conducted at both business unit and individual levels. Compliance responsibilities, likewise, should be an explicitly stated part of all job descriptions and ethical performance (including such intangibles as leadership, staff development, etc.) part of a “balanced scorecard” evaluation.

Are regulators and other stakeholders constructively engaged?
Regulatory compliance is often regarded as additional bureaucratic drudgery—an unwelcome set of tasks above and beyond those already imposed by a company's fundamental compliance responsibilities. One way to mitigate this sense of external imposition is for companies to maintain an ongoing dialogue with regulators.

FEW COMPANIES KNOW HOW MUCH THEY REALLY SPEND ON COMPLIANCE, MUCH LESS WHAT THEIR COMPETITORS SPEND.

Such dialogue not only keeps companies—indeed, entire industries—cognisant of impending changes and new developments, but it also allows businesses to shape and influence regulation. Conducted properly and responsibly, it can also pave the way towards self-regulation for some sectors.

Is compliance managed by an appropriate mix of thinkers and doers?
There are laws and regulations enough to demand the attention of inside and outside counsel, policy issue experts, and regulatory specialists. A proactive legal department can reduce litigation costs through effective deployment of early warning systems and effective dispute management.

Deploying project management specialists is equally important, if not as readily apparent. An effective compliance programme requires—even demands—long-term vision and project management.

That long-term vision and management must include clear compliance objectives, meaningful and achievable measures of success, knowledge management, continuous improvement, and regular performance reviews to determine what is going well and what is not.

What Is Enough?

The commonly held view that you cannot teach ethics to adults does not mean that you cannot improve compliance through effective training and communication. However, even "effective" compliance cannot fully eliminate intentional and unintentional misconduct. So how do you value compliance effectiveness, and how do you justify the dollars spent on it?

Few companies know how much they really spend on compliance, much less what their competitors spend. Nor do they necessarily know what they should spend to achieve the optimal cost-benefit balance.

Evaluating compliance management, its efficiency and cost-effectiveness, is problematic, since it crosses the boundaries between risk management, legal, human resources, finance, internal audit, and other functions. Finding reliable measures of compliance effectiveness is difficult for a number of reasons, the most obvious of which is that compliance costs—and benefits—may be both direct and indirect.

Notwithstanding the intrinsic value of ethical conduct, companies are typically required to justify increased compliance effectiveness by translating it into a measurable cost-benefit. Over the long term, a company with a systematic approach to compliance measurement can begin to measure the benefits of compliance in terms of:

- Value to reputation
- Value to share price as impacted by new stock exchange indices focusing on sustainable business
- Value to employee productivity and morale
- Reduction in litigation costs, i.e., minimising the cost of non-compliance.

With the cost of non-compliance typically many multiples of the cost of compliance, an effective compliance function is a form of contingency planning and effective cost management to enable a smooth-functioning organization.

Christopher Michaelson, a Senior Manager in PricewaterhouseCoopers' Compliance, Organizational Governance, Regulation, and Ethics (CORE) practice within Global Risk Management Solutions, assists companies in defining the management strategies, training and communication programs, and related accountability processes that motivate, measure, and monitor a compliance-supporting culture and promote effective corporate governance.

Working directly with senior management and boards of directors and with employees throughout client organizations, Christopher has managed clients' compliance office functions; assessed organizational compliance and governance programs; delivered communications and training to thousands of client personnel; developed codes of conduct and traditional and technology-enabled training programs; conducted e-market regulatory risk assessments, and managed privacy and data protection risk assessments.

He has written several articles on governance, compliance, and ethics for business and academic publications. Prior to joining PwC, Christopher worked with corporate associations examining global business ethics issues and taught at the college level. He can be reached by e-mail at christopher.michaelson@us.pwcglobal.com.