

COST ASPECTS OF COMPLIANCE IN REGARD TO THE VALUE ADD OF APPLIED MEASURES TO ENHANCE ETHICAL BUSINESS CONDUCT

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Abstract

Compliance management systems provide assurance for a company and help to stir the business in accordance with internal and external rules and regulations. This paper elaborates on the cost aspect of compliance. Compliance measures cost money and it is asked by business executives if the money spent on compliance is wisely spent. Starting from a conceptual approach and based on a laboratory experiment concrete suggestions for meaningful activities are made.

Keywords: Compliance management systems, costs, value add

Introduction

Last year the World Bank concluded from surveys done with over 130.000 business organizations in 135 countries that over a third of them identify corruption as a major constraint. (World Bank, 2013). On the other hand, legal requirements demand a reaction from business organizations: “Companies are held accountable, through their records, for compliance with laws.”(Willis, 2005, P. 91) With this trend towards an increase of legal obligations, it can be concluded that compliance management systems are more likely to be installed as an answer to modern challenges. Compliance management systems can help in this regard. The question about costs and value add of compliance management systems is valid and demands a discussion with a broader horizon. The value add can be defined in different terms such as image, reputation, internal improvements etc. For the purpose of this paper a monetary definition is in scope. The value add is defined as the positive impact reached compared to a scenario where no impact from an application of a compliance management system to reduce the overall costs is reached. Always keeping in mind that compliance is a cost driven function in the first place with governance character, it must be noted that the compliance function as of today is very differently installed in organizations. First of all compliance management costs depend on the people employed and the size of the organization. The quality of services rendered plays a crucial role, too.

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Research has focused on the possible measures which can be taken within the framework of a compliance management system. This is understandable because first of all measures have to be applied to ensure an integer business conduct. Building on this applied compliance seeks out to understand if measures have an impact or not. Only those measures should be applied which do have an impact. The need in the business has been recognized as “generating new empirical evidence to establish more directly the ROI [Return Of Investment] of Compliance and ethics activity could be of significant assistance to the business community.” (Greenberg, 2009, P.21) The longing for an ROI of compliance is understandable as every entrepreneur wants to know whether the taken investment is

worthwhile. The basic costs to bear in mind are personnel costs, travel costs and infrastructure costs such as office space. Compliance management systems aim at risk reduction, therefore when a risk definition is created, it can be tried to encounter this risk with specific activities. A risk for an organization may be defined as the impact it has on the organization (e.g. financially) and the probability of realization. This can be illustrated by one of the scenarios from an experiment which was conducted to test whether assumed cause-effect relationships are valid. In one scenario participants of the experiment were asked whether they would make a facilitation payment to get a colleague who is held up through the customs quicker. This scenario is deemed realistic as the fact that facilitation payments at the borders are made in specific countries has a high probability. The impact of a single facilitation payment is rather low for the organization, on an imaginative scale from 0 to 10, where 0 means no impact and 10 means high impact. The reason for that is that the execution of a facilitation payment can lead to investigations or fines, but they would be limited to a small number of persons being involved, possibly single persons. If not executed in a systematic way, the organization itself would most likely not be in focus of an investigation. Of course it has to be taken into account that persons who receive a facilitation payment can be public officials. In the example the facilitation payment might have an impact of 2, this means a rather low impact. The probability from 0 to 10 might be 4. This guessing is based on the experience management has with the application of such a forbidden practice. A simple formula could be formulated as result of impact times the applicability to calculate the risk for the organization. This risk could be evaluated with a monetary value connected to the calculated value. It must be kept in mind that risks are always a construct of perceptions. Risky activities for one group of persons might be completely risk free for another group of persons. The activities which are applied to prevent facilitation payments are the use of instructions, the information via a circular to the topic and the possibility to call a hotline telephone number with a compliance specialist who can consult. Detective mechanisms might be based on control activities. As long as the costs of compliance measures applied are smaller than the risk costs materialized in the risk scenario the application of compliance management systems seems meaningful. For that purpose it is necessary to enhance the risk assessment with the costs which are incurred. If compliance measures can prevent the materialization of risk, the general equation would be

$$\text{Calculated risk costs} - \text{Costs of compliance} = \text{Value add of compliance}$$

Figure 1. Relationship between costs and value add of compliance
Source: Own depiction

The figure above shows that the value add of compliance depends on the calculated risk costs and the costs of CMS activities which have been deducted from them. The benefit over the period of time would be to see what kind of risks can be addressed via CMS and which have also a financial impact. In a laboratory experiment by the author compliance measures were tested which seemed to positively influence the decision behavior of individuals. The hypotheses underlying the testing procedures demanded that there is a difference in the decisions taken by persons who have been ethically sensitized compared to persons which did not experience such a treatment. The results for the laboratory test which show a significant difference between control and treatment group are shown below:

Variable	Item	Significance level
Control	Making a donation	0,004
Control	Payment to "black listed" external partner	0,000
Control	Payment to supplier	0,004
Information	Invitation to go skiing with competitor	0,009
Instruction	Video Beamer	0,010
Instruction	Facilitation Payment	0,024
Instruction	Mergers and Acquisition	0,000
Reporting	Reading News	0,034
Reporting	Documentation of invitations	0,017

Figure 2. Overall result of items with significance level <0,05
Source: own illustration

The table shows that for 4 out of 5 variables items could be identified which can be judged as influential. For the variable *Sanction*, for no item the null hypothesis could be rejected. For all other items relating to the hypotheses the group means can not be judged as significantly different. The conclusions drawn can not be stated without a risk of mistake. To illustrate the findings, the variable *Instruction* is closer examined. The hypothesis on *Instruction* states that the more instructions are given the higher the influence on legal/ethical right decision. Instructions can be given on different layers of the hierarchical organization. A top-down approach normally gives general guidance and rules from the top level which has to be refined on sub levels. It can be the cases that in a very small unit consisting of only a few employees detailed instructions are given. It must be considered that instructions are not in contradiction with other regulations: "Policy statements naturally suffer from some of the same defects as ethical codes. Policies cannot cover all possible situations; they are not prioritized, and they may lead to conflicting and potentially incompatible instructions." (McDonald & Zepp, 2007, P.62)

The variable *Instruction* was tested in 4 items: "Video Beamer", "Mergers and Acquisitions", "Check of Business Consultant" and "Facilitation Payment" For three of the items, the Mann-Whitney test shows an asymptotic significance value of 0,010, 0,000 respectively 0,005 which indicates that the hypothesis both groups are the same (H₀) is rejected. As the assumption of equal means is rejected, it can be concluded that there is a significant difference between the groups concerning the variable *Instruction* in the items "Video Beamer", "Mergers and Acquisitions" and "Facilitation Payment". The alternative hypothesis for the variable with that item would be "The more instructions are given the higher the influence on legal/ethical right decision." For the item "Check of Business Consultant" the hypothesis H₀ could not be rejected.

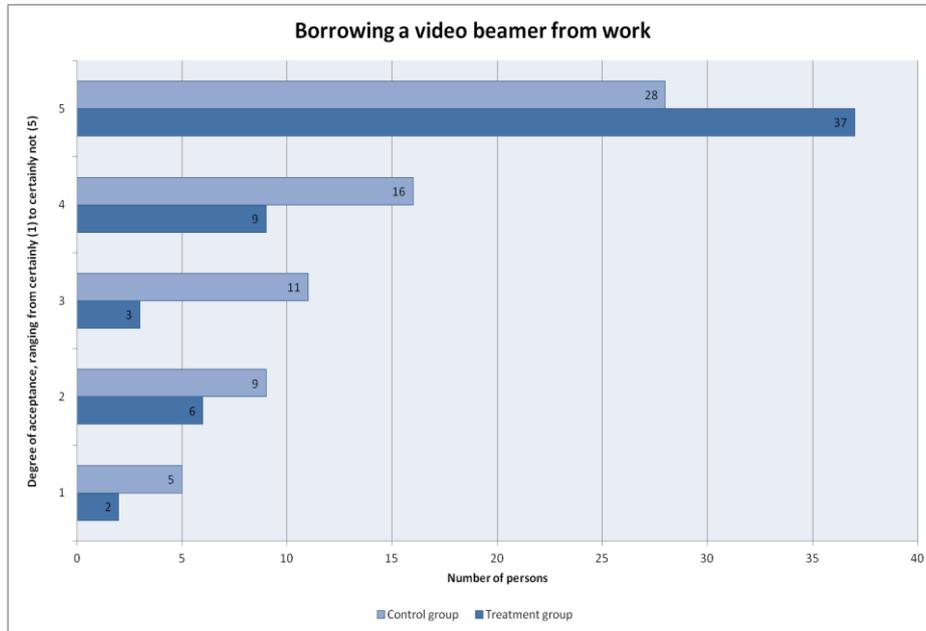


Figure 3. Borrowing a video beamer from work
Source: own illustration

In the item “Video beamer” both the treatment and the control group are mainly of the opinion that the borrowing of company assets for private purposes is not in the interest of the organization. The treatment group was manipulated in the way that a hint was given to them that it is written down that the borrowing is forbidden to take the beamer overnight. The control group which did not have this hint shows similar answering behavior, but a stronger tendency towards a higher degree of ethical behavior is noted in the treatment group. With a two-tailed asymptotic significance value of 0,010 it can be concluded that the hypothesis concerning ethically sensitized persons and ethically not sensitized persons making a payment to the same degree can be rejected with an error probability of 1,0%. This means that the hypothesis H1 is valid for the population.

As noted before this range is small, but the instruction does have a significant influence.

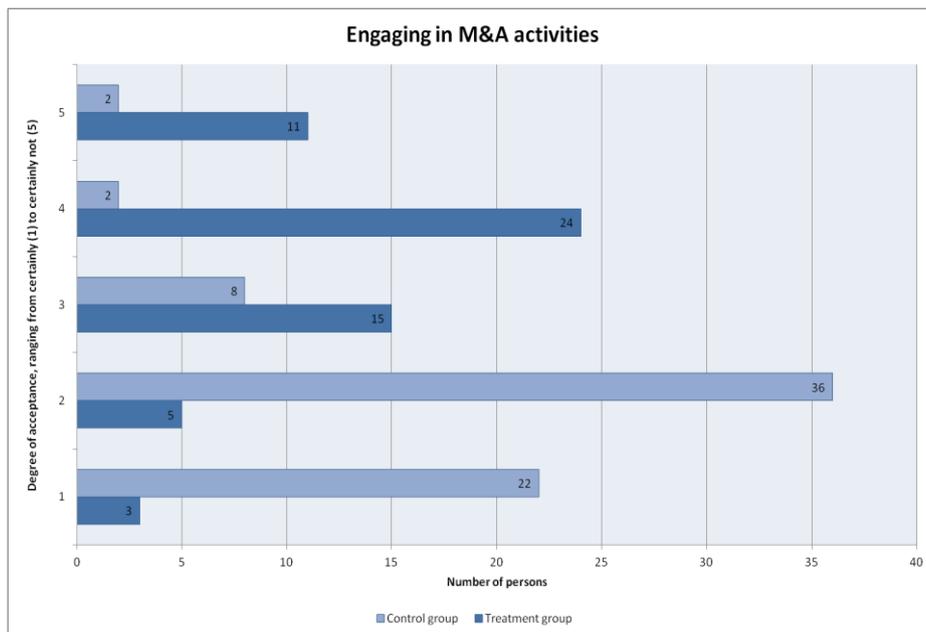


Figure 4. Accepting a M&A-Deal proposal
Source: own illustration

The item “Mergers and Acquisitions” shows a strong degree of consent in the control group. 22 persons would certainly and 36 persons would almost certainly accept the proposals. In the treatment group this is only true for 3 persons concerning a certain acceptance and almost certain acceptance. In the treatment group 24 persons would rather not accept the proposals and 11 persons would certainly not accept the proposals. The significant difference lies in the manipulation of the variable. The treatment group was informed that M&A specific instructions revealed risks which are not covered. Furthermore with a two-tailed asymptotic significance value of 0,000 it can be concluded that the hypothesis concerning ethically sensitized persons and ethically not sensitized persons accepting the proposal for a M&A Deal to the same degree can be rejected with an error probability of 0%. This means that the hypothesis H1 is valid for the population.

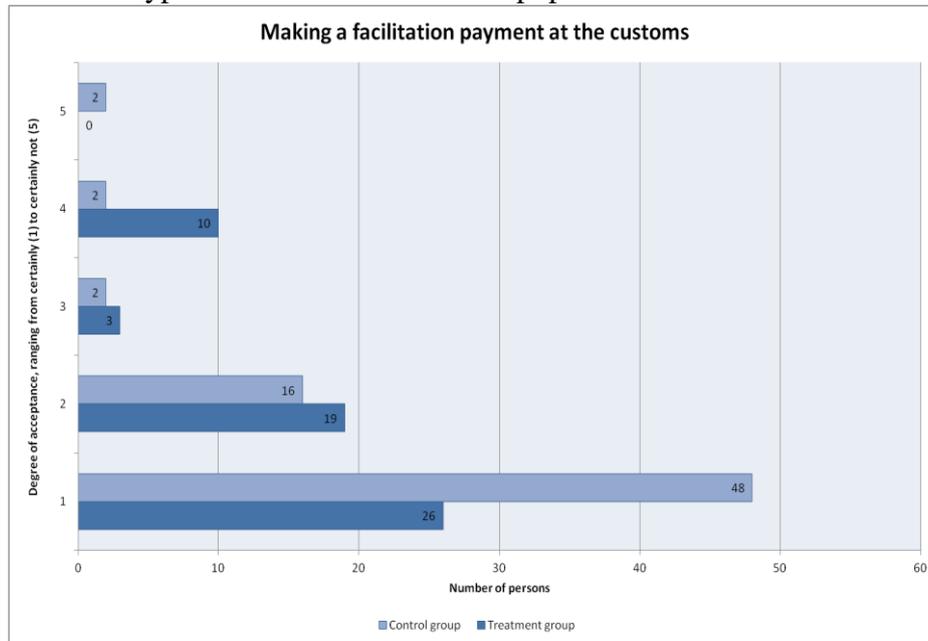


Figure 5. Making a facilitation payment
Source: own illustration

The third item facilitation payment shows a high degree of consent from both treatment and control group. 26 persons of the treatment group and 48 persons of the control group would make a facilitation payment to customs authority. The instruction which forbids such kind of payments was given to the treatment group, but even with this instruction almost half of the person in the treatment group would make a facilitation payment in the situation which puts a lot of pressure on the test persons. The test persons were confronted with a situation in which a team member is held up at the airport. Only with the payment of US\$ 150 which is requested by the authorities at the airport in Nigeria the person can pass. This shows that the introduction of an instruction does have a significant influence, but the instruction can not hinder the engagement totally. The rejection by 2 persons in the control group, but no persons in the treatment group reveals that there are individuals who judge despite the fact that they did not receive an instruction in an ethically right way. Furthermore with an asymptotic two-tailed significance value of 0,005 it can be concluded that the hypothesis concerning ethically sensitized persons and ethically not sensitized persons making a facilitation payment to customs authorities to the same degree can be rejected with an error probability of 0,5%. This means that the hypothesis H1 is valid for the population. This result underpins research on regulatory aspects which deem coercive measures success factors: “Coercive enforcement measures remain an essential ingredient in any compliance

regime, even where a high degree of compliance is realized via the twin forces of moral obligation and social influence.”(Sutinen & Kuperan, 1999, P. 187)

Overall, the hypothesis H0 could be rejected for 4 of 5 variables, as a significant difference between the treatment group and the control group was calculated in specific items. For one variable the significance level does not allow for rejection of the hypothesis H0. From the item analysis it can be shown that not all items led to this conclusion. A few of the items apparently do not have a significant influence. It appears that given information must be very precise and concrete otherwise it does not have the desired effect. General information is not helpful. Sanction mechanisms obviously play a minor role in improving ethical behavior. The reporting schemes or requirements do also not have a major impact on the sensitization of ethical acting. Practical conclusions are that compliance management systems do have a positive influence generally. The highest influence can be attributed to activities which are based on Information, Controls, Instructions and Reporting. However these activities must be designed specifically to individual needs. Bringing in context the topic of costs of compliance and the results of the laboratory experiment it seems most promising to select first of all activities which can be implemented swiftly. The creation of an instruction might be done rather fast.

Control activities are appropriate measures to decrease the corruption risk. The costs for the implementation depend on the types of controls. Labor intensive controls might be the double or triple checking of payments and bills. This could be supported by an IT work flow e.g. in the area of payments. Other controls might be the use of an independent assessor. For all control scenarios it would be possible to calculate a cost estimation. This estimation could be used to approximate a value add for the compliance function.

Another cost-efficient lever to ensure that business is done in accordance with rules and regulations would be the use of instructions. As compliance measures instructions have been found out to be very effective. The costs associated with that would be the draft and publication of the instruction and beforehand the knowledge which has to be gained to be able to publish an instruction which is useful. This is a labor-intensive process, but research shows that this is well invested money and costs are recovered as these measures are perceived to be very effective.

Conclusion

Admittedly the monetary consideration is only one way to look at the value add of compliance. A pure focus on costs would be a limiting view as effects which are not easily measurable are not considered. The costs which compliance activities inherently cause must be seen in proportion to the risk costs. If risk costs are very high then seemingly moderate to high costs of compliance can still produce a value add as the value add outweighs the risk costs. The same costs of compliance in a risk free environment do not produce a value add as they can be judged superfluous. In a risk free environment expenses for compliance can be saved. Therefore a regular cost monitoring seems necessary. Only with a holistic view on both costs and value add a weighted judgment of the right balance is possible. It is task of the management to judge on the necessity of the scope of the compliance management system and the scope. This can be done via risk assessments which also include business experience and experience in specific markets and with the products/projects which are sold. The question about the ideal compliance management system is foremost a question about the risk portfolio, the size of the company and the attitude of its employees. An organization being located in rather low risk countries and operating in these countries is exposed to a relative low level of risk and might therefore not need a complex compliance management system. Multinational conglomerates are encountered with a higher risk portfolio as they operate in lots of countries, several of these are more risky countries. The size of the company has also

an impact of the compliance management system. A small or medium enterprise might not have the need to formulate a compliance management system as the owner can give clear directions and the employees know what is expected of them. The bigger the organization the more probable is the need for a stronger formulated compliance management system. Training activities which are necessary as preventive measure as one example are resource intensive and demand if done on a personal base a compliance management system which has the capability to provide personal trainings, possibly tailored to specific target groups. The approach via only online trainings which are cheaper does not have the same effect as personal trainings which offer the participants the possibility to ask questions and discuss scenarios. Finally it can therefore be concluded that the budget for compliance should be based on the risk the organization is encountering. Several compliance measures can be installed relatively inexpensive, but to ensure proper risk mitigation, savings should not be made on preventive measures as the costs which might be incurred by fines can be a lot higher.

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