Reconfiguring Compliance for Corporate Social Responsibility

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Abstract

Corporate compliance exists as a separate function in many large organizations. Some firms treat it as a part of the legal department, others as part of a separate compliance group, still others as part of human resources, and some as part of internal audit. Regardless of its placement compliance is likely to be somewhat reactive responding to breaches of conduct and violations of existing law. Measures of compliance tend to focus on wrongdoing (number of violations) rather than prevention (number of violations avoided) predominately because of the difficulty in measuring and assessing prevention. We envision compliance as a more active part of corporate governance, specifically as an extension of management’s responsibility to create an ethical culture in organizations. This places compliance at the heart of corporate social responsibility thereby forcing it to take on a more proactive stance. It also better aligns it with organizational strategy and emphasizes lead measures rather than lag measures (e.g. number of prevention steps as opposed to number of violations). Our manuscript discusses what we think is required to make this transition including the difficulties we foresee. Management and its Board of Directors will need to be actively engaged to promote and enable this process. Additionally, policies, procedures and systems will be necessary to support such a transition. We build our proposals on the theories of regulation, moral development, internal control, and learning. We conclude that internal audit is not the correct location for a compliance function. However, we feel that it may
serve as a fitting model for compliance since it possesses several critical aspects that would serve compliance well.

**Keywords:** Compliance, Regulation, Corporate Governance, Corporate Social Responsibility

**Introduction**

This manuscript is intended to explore the concept of compliance as it relates to both corporate governance as well as corporate social responsibility. We seek to elevate compliance beyond its current level and status which tends to be rule oriented, reactive, and externally driven. While rules and regulations will always exist, we believe that organizations can be much more proactive and internally driven. We argue that organizations want to self-govern as much as possible and therefore, may wish to raise compliance into the realm of corporate social responsibility. We believe that this will require some fine-tuning of corporate culture due to the fact that such a change requires an adjustment in thinking about risk and involves more than a self preservation mentality. This changes thinking from an externally focused and mandated ‘culture of compliance’ to an internally focused socially responsible ‘culture of accountability.’ In essence, a change in thinking from ’have to’ to ’ought to’ as it relates to meeting regulatory obligations.

**Corporate Governance**

Corporate governance consists of a system of processes, rights, duties, and measures by which an organization regulates, monitors, and controls itself. A combination of the board of directors and senior management works to administer the organization (Pearce & Zahra, 1992). Regulation
includes decisions, rules, and procedures created by the organization which guide it toward its goal of self-governance. But not all regulation is internally created. Societal desires that relate to the organization become laws and regulations with which it must comply. These codified artifacts guide collective organizational behavior of managers and employees. Organizations interpret these artifacts as rules and procedures by which they can monitor and control themselves as part of their overall governance process.

**Theories of Regulation**

Why does regulation exist? In the American legal system, at least in part, administrative regulation moves lawmaking out of the realm of representative government into a “zone of government by specialists presumed to act according to more disinterested and scientific judgments of good social policy (Aman and Mayton 2001).”

Theories of regulation discussed by social scientists and economists emanate from the premise that regulation exists to correct market failures (Lee and Clark 2013). These corrections take the form of fixing of prices above or below free-market equilibrium, taxes, subsidies, direct production of goods or services, and legislative and administrative controls, including sanctions (Sloman 2006). From this premise of market correction, three significant theories have arisen.

The Public Interest Theory (Davis 1958) posits that regulation is supplied by agencies to respond to the public’s demand to correct inefficient or inequitable market practices. This Public Interest theory is aptly described in Dia Navigation (1994) as introduction of “public participation and
fairness to affected parties after government authority has been delegated to unrepresentative agencies.” This theory is predicated on two assumptions:

- Economic markets are fragile and likely to operate inefficiently or inequitably if left alone;
- Government regulation is virtually cost-free.

Posner (1974) has noted several deficiencies in this theory, not the least of which is that it implies that regulation would be imposed primarily in highly concentrated industries and in those industries that generate substantial external costs or benefits; this is not borne out in reality. Next, the notion of government regulation as being costless was long ago refuted (Hirshleifer, DeHaven and Milliman 1960). Posner further challenges the assertion that failures in regulation are due to agency mismanagement or employees’ lesser ability vis-à-vis private sector employees.

A second theory is known as the Capture Theory. In this theory, the regulatory process is one by which interest groups seek to promote private or personal interests (Bentley 1908, and that over time, according to Bernstein (1955), the respective regulatory agencies will become dominated by the industries regulated. This theory is now widely discredited (Posner 1974).

The Economic Theory was first proposed by Stigler (1971). Under this theory, capture may be effected by groups other than regulated firms. It assumes that people will seek to advance their respective self-interests in a rational manner. Economic regulation is a product, governed by the law of supply and demand, to bestow valuable benefits on particular individuals or groups. The
supply and demand curves can be located by the theory of cartels. These cartels inform benefit and cost sides of the process.

The value of a cartel is indirectly related to two factors, elasticity of demand and ease of entry into an industry. Other than punishment where a cartel is illegal, the theory identifies two major costs of cartelization: the cost to sellers of arriving at an agreement as to price and output, and the cost of enforcing the cartel agreement against those who declined to participate, or who defected from the cartel; the individuals or groups are “free riders (Posner 1974).”

Under this theory, demand for regulation is triggered by a perception of value in regulation, with demand being greatest where private cartelization is either unfeasible, or is a costly alternative to regulation. The demand for regulation requires that those requesting regulation be amenable to introduction of the political process, that is, regulation by governmental agency/agencies. Under Stigler’s theory, it may be less expensive for large-member industries to obtain public regulation than to cartelize.

According to Posner, Stigler’s theory also accounts for three forms of political systems to be found in democratic nations. A democratic system awards legislation by majority vote. The entrepreneurial system “sells” legislation to industries that most highly value the legislation. In the entrepreneurial system, the cost of “free riders” becomes irrelevant as the government’s coercive power overcomes those “free riders.” The final form is the coercive system. In this form, legislation is awarded to groups able to make credible threats of retaliation if not treated favorably, with that retaliation taking the form of violence or economic consequences.
Once regulation has occurred, there is a life cycle to the regulation. Tomain (2000) identifies a six-step process:

**Stage 1** is a free market with no regulation; because of its inherent fairness and efficiency, no government intervention is necessary.

**Stage 2** is recognition of market failure, with a suggestion of governmental regulatory response.

**Stage 3** is government regulation. Justification for government intervention must occur at this stage. Further, the response must utilize the correct tool of regulatory improvement.

**Stage 4** is regulatory failure, where cost outweighs the benefit of the extant regulation. The government must now select which of the remaining steps to follow.

**Stage 5** is modifying current regulation.

**Stage 6** is elimination of the regulations, returning the industry to the Stage 1 free market phase.

The authors suggest that Stages 5 and 6 may run contrary to the natural tendencies of the agency, reducing the efficacy of the regulatory process. This would be particularly the case with respect to elimination of regulations.

Resistance to change is natural (CUTS – UWM, 2014), and may be based on several factors:
• When the reason for the change is unclear.

• When the proposed users have not been consulted about the change and the change is offered to them as an accomplished fact.

• When the change threatens to modify established patterns of working relationships between people

• Insufficient communication about the change

• When the benefits and rewards for making the change are perceived as inadequate for the trouble involved

• When the change threatens jobs, power or status in an organization.

Of these factors, threats to established patterns of working relationships, inadequate benefits and rewards, and threats to power or status seem most pertinent to regulatory agencies. This inherent resistance to change, coupled with the somewhat lengthy process promulgated by the Administrative Procedures Act of 1946, may provide an impediment to effective implementation of a proactive socially responsible compliance function.

**The Compliance Function**

The compliance function (hereafter compliance) serves to keep the organization aligned with various external regulations with which it must contend. It functions as part of the governance process within organizations. Since the sources of these rules exist outside the organization, the compliance function is somewhat inclined to take on a reactionary role. Organizations assemble a series of processes including compliance as part of their governance mechanisms. These form a ‘corporate immune system’ used to maintain an organization’s health (Simmons, 2013).
Corporate governance is affected by the control systems chosen by an organization’s managers. Simons has suggested that control systems both reflect strategy in organizations as well as affect its formulation (Simons, 1987, 1991). Some control system attributes cause manager focus to be directed toward specific outcomes while ignoring others which can then be delegated or excluded.

Organizations tend to create internal groups to interact with specific external factions or sectors of their environment. Two environments are usually considered, the task environment and the general environment. The task environment consists of sectors with which an organization has direct interaction and which will contribute directly to the achievement of the organization’s goals. These would include its industry, direct materials, human resources, and the market sectors. Researchers define the task environment as having three dimensions; complexity, dynamism (speed of change), and munificence (availability of resources) (Dess & Beard, 1984; Sharfman & Dean, 1991). Through examining these forces an organization defines a structure through which it will interact with its environment. If the environment is complex and constantly changing, the organization must develop a more flexible approach with roles that can change and adapt quickly. If the environment is stable, a more structured approach with limited roles is appropriate. Based on the level of resources available, the organization may be forced to seek alliances to ensure supplies, or may be alright fending for itself.

The general environment consists of sectors that have less direct impact on the achievement of an organization’s goals and objectives but still influence organizational outcomes. These may include technology, financial resources, and regulatory (including but not limited to government). A logical conclusion for alignment to regulatory requirements and the law is to
create a compliance group as the liaison to regulatory agencies. However, over time working with various laws, this function may begin to take on a legalistic viewpoint. Such a group may have as much motivation to cover up wrongdoing as to uncover it since their focus is to reduce legal risk within the organization. Rules become institutionalized when they are acknowledged across the organization. Once accepted, institutional rules may give rise to formal organizational structures because they form a basis for legitimacy and this legitimacy will also translate into enhanced prospects for survival (Meyer & Rowan, 1977). In other words, once legitimized, there is little reason to disband an internal group that seems to serve a justifiable function. It is important to arrive at a functional definition of “compliance.” The implication is that “compliance program” denotes a primary concern with following rules and regulations, while “integrity or ethics program” elevates the emphasis to include values and “doing the right thing (Society of Corporate Compliance and Ethics 2004).” As for many organizations the emphasis remains at the stage of following promulgated rules and regulations, we use the narrower definition in this paper.

**Corporate Social Responsibility**

Corporate Social Responsibility (CSR) goes beyond a governance structure responsible to stockholders/owners. Although Dahlsrud (2008) found that most definitions of CSR depict it as more of a phenomenon than a true definition, CSR recognizes the organization’s impact on multiple stakeholders including employee, customers, investors, the communities in which it functions, the environment, and society as a whole. Mason and Simmons (2014) proposed a stakeholder model of CSR that aligns it with corporate governance and addresses many of the shortcomings of treating CSR as an idea rather than a process. CSR considers how an
organization affects its environment and takes as strong an interest in the value of ethics as it does the value of profits. In their work on corporate ethics, Reidenbach and Robin (1991) identified five levels of corporate moral development. These included the amoral, legalistic, responsive, emerging ethical, and finally the ethical organization. In the current manuscript we are concerned with the distinctions between the legalistic, the responsive, and the emerging ethical organization levels. When an organization occupies the legalistic stage of moral development it is focused primarily on rules, both internally and externally generated.

Compliance with established rules is seen as a way to produce good for the organization and protect it from harm. Corporate values flow from existing rules and consequently these organizations remain followers and not social leaders (Reidenbach & Robin, 1991). Once a firm has become a responsive organization there is a balance between following rules and following a moral compass. Outside pressures from stakeholders cause the organization to recognize that it has social duties and obligations that reach beyond its responsibility to stockholders. At this level the firm is cognizant of its greater social role but according to Reidenbach and Robin (1991), is still not doing what’s right for the sake of what’s right. When a firm inhabits the emerging ethical level of moral development, it will actively seek a balance between ethics and profits (Reidenbach & Robin, 1991). We see this as the preferable level at which to establish a compliance function moving from rule keeper to moral seeker.

Compliance, when reacting to laws and regulations, tends toward the legalistic level since it is primarily concerned with meeting existing requirements. It measures items such as the number of infractions/violations, fines paid, complaints (including sources of complaints), hotline calls, sanctions enacted, recalls, and employee turnover. It takes on a somewhat defensive nature that
defines ethical behavior as meeting requirements and avoiding violations. In order to move beyond this legalistic level, an awareness of greater social responsibility must be established and communicated by management. The emerging ethical organization is a more proactive entity actively exploring its impact amid a myriad of constituents all of which have concerns regarding corporate decisions and actions. We propose moving an organization’s focus to this level whereby active search for potential issues, preemptive measures, and continuous improvement are the norm. This represents moving from a prescriptive stance to a prescriptive one.

However, one of the key components of creating such a shift is aligning the corporate culture. One might say that culture is to organizations what personality is to individuals. The values, beliefs, traditions, and norms that make up a personality become shared as groups form into organizations. Culture consists of shared values and beliefs. Moreover, traditions, rituals and even myths become part of a culture (Schein, 2004). Once accepted and institutionalized, an organization’s moral fiber becomes embedding in its culture. Culture’s shared values define the level of moral development at which an organization will function. This is in essence moving from a written code of ethics to a dynamic living code of ethics anchored in the moment and supported by a strong and enduring moral foundation. Recent work on CSR gives indications that stockholder expectations may be moving from praising any effort toward CSR to a negative reaction to firms that ignore environmental issues (Flammer, 2013).

**Changing Compliance**

Moving compliance to a more active, ethically sensitive function will require commitment by management and the board of directors who form the primary governance of the organization.
Without the visible commitment of the leadership, organizational members will ignore hollow appeals to prevent problems and comply with rules. Organizational values will be mirrored in the resulting behaviors. Therefore, first and foremost, the leadership of the organization must choose a proactive stance that reflects a desire to be ahead of problems, breaches of ethics, or violations. Ethical standards should be developed which encourage CSR (Valentine & Fleischman, 2008). This ethical stance must be shared openly in the organization and deviations quickly and forcefully addressed. The culture must be aligned with appropriate values and norms. In order to proactively govern, management must move beyond status quo to vigorously encourage integrity (Verhezen, 2010) and demonstrate their commitment to compliance values (Parker & Nielsen, 2009).

Procedures and rules need to conform to the desired behaviors. Once such a status is reached the placement of the compliance function becomes one of where can it be most effective. It is unlikely that it would remain attached to the legal department considering that it will have moved closer to other stakeholders and must concern itself with far more than litigation and fines. Additionally moving from the legalistic level to the emerging ethical level of corporate moral development (Reidenbach & Robin, 1991) calls for a new style of thinking about compliance issues framed in a more holistic manner. From a management perspective, there are motivating factors such as evidence that organizations that actively embrace CSR tend to have better financial performance (Ntim & Soobaroyen, 2013). Other researches indicate that firms who engage in CSR better manage risk (Jo & Na, 2012). We agree with the work of Basu and Palazzo (2008) who propose a process model of CSR whereby managers actively consider how they view and act with respect to key stakeholders. Such dialogue is necessary for the change in
compliance we endorse. Additionally, the work of Yuan, Bao, & Verbeke (2011) regarding CSR adoption is extremely useful and provides a roadmap. They propose a number of integration approaches which depend on the readiness of the organization to accept CSR.

Size of an organization could be a factor that inhibits the effectiveness of an effort to reconfigure compliance. When taken from the CSR perspective firm size provided advantages and disadvantages. Small firms were found to have the advantage for implementing CSR while larger firms found advantages in external communications regarding CSR efforts (Baumann-Pauly, Wickert, Spence, & Scherer, 2013). We feel that it will be easier for smaller firms to embrace a new configuration of compliance simply because of fewer numbers of employees involved. However, limited resources could limit effectiveness. Commitment from the top and consistency in follow through will be the most compelling reasons members will have to change behaviors regarding regulation.

**A Possible Model for Compliance**

We considered one possible model for a more proactive compliance effort might be relocating its function to the internal audit group in a corporation. Internal audit has natural strengths that provide a desirable alternative to existing compliance groups. They report directly to the board of directors bypassing management scrutiny and censorship. They maintain independence within the organization and have a wide operational scope. Audit has access to data gathering mechanisms that make them a central data hub within an organization. However, because internal auditors are required to maintain a certain level of independence and objectivity, this would restrict them from assessing the compliance function since they would be auditing their
own work. This was considered by Henry in her article in Internal Auditor magazine (2011). Additionally it would cause them to limit the scope of other internal reviews away from any type of compliance.

So while we concede that internal audit may not be the correct location for the compliance function, we feel that it may serve as an appropriate model for compliance since it has three aspects which seem to serve it well. First it reports directly to the board of directors bypassing the management chain. This is done to ensure that significant findings cannot be suppressed by management and creates a transparency required by CSR. Second, it has processes in place to measure and assess a variety of organizational dimensions including compliance to external as well as internal regulation. Lastly, internal audit departments view an organization holistically and provide the broadest perspective when considering their charter. So too could a compliance group seeking a broader CSR approach benefit from such a structure enabling them to deepen their effectiveness and change the organization’s impression of them as policing the organization to one of enabling the organization.

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