PREVENTIVE LAW AND MANAGERIAL AUDITING

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Introduction

The corporate sector has learnt some expensive lessons in recent decades on the costs of inadequate auditing systems to ensure compliance with the law — the Lockheed bribery scandal, thalidomide, Bhopal, Allied Chemical and Kepone, A.H. Robins and the Dalkon Shield, asbestos; and these are just the high-profile cases which generate newspaper headlines. In more mundane ways, large corporations are confronted every year with instances of employees breaking the law on behalf of the corporation in their enthusiasm to achieve the goals they have been set by the organisation.

Of course, it is sometimes in the corporation's interest to break the law, but most large corporations rightly take the view that to allow a culture of lawlessness to develop within the organisation will be to the long-term disadvantage of the corporation. The corporations which allow employees to play fast and loose with the law are the ones that end up with billion dollar legal disasters. Moreover, the American foreign bribery scandals of the 1970s taught us that corporations that turn a blind eye to slush funds find that while that eye is closed their own executives are helping themselves to the monies poured into off-books accounts. In short, corporations which have a climate of tolerance towards illegal means of corporate goal attainment in a variety of ways tend themselves to become victims of corporate crime.

The Corporate Response

The upshot of this realisation has been that many companies are now responding constructively with preventive law programmes which draw on the experience of managerial auditing. These have been devised in a variety of areas, notably the following:

- product liability;
- occupational health and safety;
- companies and securities law requirements;
- restrictive trade practices;
- revenue law;
- consumer protection;
- environmental protection, and
- data protection.

Why the importance attached to compliance controls? The main reason is clear; prevention is often more cost-effective than cure. The costs to be avoided are well known but bear repeating:

- heavy civil damages (e.g. for products liability);
- product recalls or other corrective action;
- trading losses resulting from unauthorised acts of employees;
- disqualification of licence or authority to transact business;
- disruption and loss of morale as a result of involvement in litigation or a publicity crisis;
- fines, or, in some instances, even jail;

- legal costs in defending claims or prosecutions;
- increases in insurance premiums, and
- spectre of increased regulation.

Beyond these obvious motivations for having effective internal controls, there is a trend towards enforced self-regulation, with the state delegating its enforcement role to private enterprise and coercing private enterprise to discharge that role on its behalf.

How, then, can large organisations respond to the challenge of making their self-regulatory systems work better to ensure compliance with the law?

The Essential Requirements of an Effective Self-regulatory System

One of the authors examined, largely on the basis of interviews with executives, the characteristics of the internal compliance systems of the five American coal mining companies with the lowest accident rates for the industry in the early 1980s, and also reviewed other empirical work on the organisational characteristics associated with safety in mines[1]. A characteristic which consistently emerged was that companies with good safety records had detailed plans of attack to deal with identifiable hazards. This may be a characteristic which is not so relevant to determining the effectiveness of other kinds of internal compliance functions as it is for occupational health and safety. However, the other features which emerged from this empirical work seem to us of likely general relevance. Effectively, self-regulating companies:

(1) give a lot of informal clout and top management backing to their compliance personnel (safety inspectors in the case of mine safety);

(2) make sure that clearly defined accountability for compliance performance is placed on line managers;

(3) monitor that performance carefully and let managers know when it is not up to standard;

(4) leave effective communication of compliance problems to those capable of acting on them; and

(5) do not neglect training and supervision (especially by front-line supervisors) for compliance.

These characteristics of successfully self-regulated corporations will be considered in turn.

Clout for Internal Compliance Groups

At a recent seminar on laws to control animal experimentation, one of the authors asked the animal welfare officer from a very large Australian research institution how she dealt with researchers who refused to comply with Australia's voluntary code on the use of animals in experiments. "Easy," she said. "If they don't do what I ask, I don't give them any more animals." Her role encompassed the ordering and delivery of animals to experimenters. This gave her organisational clout in dealing with researchers. Most fundamentally, then, clout for internal compliance groups comes from their control of resources which are important to those who must be made to comply.

Clout is central in the same way to the success of government regulators. Health departments find it easier to control drug companies than food outlets, and find it much less necessary to resort to law enforcement to do so, because health departments hold sway over so many decisions which affect the success of pharmaceutical companies. They decide whether new drugs will be allowed on the market and, if so, with what promotional claims, at what price and with what quality control requirements during manufacture. Organisational actors are more compliant with requests from actors who control vital resources (such as approvals and licences) for the organisation.

Often, it is organisationally difficult to give compliance staff control over contingencies which matter to those regulated. In these circumstances, it is important for top management clearly to communicate the message to the management that, in any dispute, it is likely to stand behind its compliance staff. Regrettably, in most organisations, the opposite message is part of the folklore of the corporate culture — that, when the crunch comes, management will stand behind its production people and allow them to push aside that which impedes output. In contrast, with the coal mining safety leaders visited, when a company inspector recommended that a section of a mine be closed down because it was unsafe, in all five companies it was considered inadvisable for line managers to ignore the recommendation because of the substantial risk that top management would back the safety staff rather than themselves.

Quality control directors in many pharmaceutical companies are given clout by quite formal requirements that their decisions can only be overruled by a written directive from the corporation's chief executive. This gives quality control unusual authority, because not many chief executives want to risk their careers by overruling their technical people for the sake of a single batch of drugs when the danger, however remote, is that this batch could kill someone.

Clearly Defined Accountability

A senior pharmaceutical company executive once explained: "There's a Murphy's Law of a kind: If someone else can be blamed, he will be." Active policies to resist this tendency are needed for companies to be effectively self-regulating. At all five coal mines, leading responsible for different types of safety breakdowns. They were all companies which avoided the problem of diffused accountability: people knew where the buck stopped for different kinds of failures.

In contrast, companies with little will to comply sometimes draw lines of accountability with a view to creating a picture of diffused responsibility so that no one can be called to account should a court enquire into the affairs of the company. Everyone is given a credible organisational alibi for blaming someone else. Perhaps worse, other non-self-regulating companies calculatedly set out to pass blame on to others. Thus, some pharmaceutical and pesticide companies have their most dicey toxicological testing done by contract laboratories which survive by telling large companies what they want to hear. They get results which indicate the safety of their products without risking the consequences of a conviction for the presentation of fraudulent data. The use of sales agents to pay bribes is perhaps the best documented device of this sort in the corporate crime literature.

At three of the large American pharmaceutical companies visited by one of the authors, it was revealed that there was a "vice-president responsible for going to jail"; and two of these were interviewed[2]. Lines of accountability had been drawn in these organisations such that, if there were a problem and someone's head had to go on the chopping block, it would be that of the "vice-president responsible for going to jail". These executives probably would not have been promoted to vice-president had they not been willing to act as scapegoats. If they performed well, presumably they would be shifted sideways to a safer vice-presidency. Corporations can pay someone to be their fall-guy in many ways. Exceptionally generous severance pay is the simplest method.

Admiral Poindexter's role in the Iran-Contra operation was that of a classic "vice-president responsible for going to jail". On 16 July 1987 he told the US Congressional investigators that the "buck stopped" with him, not with the President, that he had decided not to tell the President even though he knew that the President approved of what he was doing "so I could insulate him and provide some future deniability should it leak out"[3]. In the Nixon White House, in contrast, staff did not show Nixon the solicitude of shielding him from the taint of the knowledge of Watergate, so the buck did stop with the President — where it belonged.

In summary, most companies make little effort clearly to define lines of responsibility for compliance; the result is that when something does go wrong of the organisation is usually sufficient to convict any individual. Calculatedly companies sometimes create lines of which will point the finger of responsib... their top managers. And effectively companies have principles of responsib... it clear in advance which line manage... responsible should certain types of n... occur. However, a number of the p... companies either had an each way bet; t... defined lines of accountability for their inte... purposes, while contriving to portray... confused accountability to the outside v... that the latter does occur is one reaso... police" can be more effective than "pub... why self-regulation has the potential mor... punish individuals than Government reg...

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is that when something does go wrong the complexity of the organisation is usually sufficient to make it difficult to convict any individual. Calculatedly non-compliant companies sometimes create lines of accountability which will point the finger of responsibility away from their top managers. And effectively self-regulating companies have principles of responsibility which make it clear in advance which line managers will be held responsible should certain types of non-compliance occur. However, a number of the pharmaceutical companies visited had an each way bet; they had clearly defined lines of accountability for their internal disciplinary purposes, while contriving to portray a picture of confused accountability to the outside world. The fact that the latter does occur is one reason why "private police" can be more effective than "public police", and why self-regulation has the potential more effectively to punish individuals than Government regulation.

Monitoring Compliance Performance

Two of the surprising findings from the survey of the organisational characteristics of coal mining safety leaders were that the size of the safety staffs of these companies varied enormously, as did the punitiveness of their approach to disciplining individuals who breached safety rules. It was expected that among the defining characteristics of companies which were leaders in safety would be that they would spend a lot of money on safety staff and would be very tough on safety offenders. While a large safety staff is not necessarily a characteristic of safety leaders, putting enormous accountability pressures for safety on line managers is. While a policy of sacking or fining safety offenders on the spot is not typical, communication of the message that higher management is deeply concerned when individuals break the rules is universal for safety leaders.

Ultimately, there is, of course, no standard recipe to be followed; as the director of safety at Bethlehem Steel put it: "You can't cookbook safety." However, there is a framework for legal risk management and companies are well advised to heed the basic elements of that framework when building up their own preventive programmes.

The annals of corporate disasters contain numerous examples of companies which have failed to take even the elementary step of identifying areas of prime risk. One case in point is the explosion at the Flixborough plant of Hypro Ltd in the mid-1970s. The explosion, which killed 28 people, occurred in an environment where the awareness of such a risk seemed to be minimal if present at all:

  . . . the plant operated by this organisation held over 360,000 gallons of cyclohexane, naphtha, toluene and gasolene on a site which was licensed to store only 8,500 gallons; . . . there were associated "shortcomings" in its safety procedures and uncertainties about responsibilities for safety; . . . a major repair to a plant processing very large quantities of cyclohexane at high temperatures and pressures was carried out with limited design, inspection and test procedures . . . . Hazards on the scale which emerged were not being "responded to" by Hypro, simply because they were not imagined or considered . . . The Flixborough case presents in perhaps an extreme form the characteristics of intelligence failure or of the failure of foresight which is charted in most retrospective inquiries into accidents[4].

Risk identification can be conducted at an ethereal mathematical level, but legal risk management typically requires the use of check-lists, systematic reviews of corporate operations, "what if" projections and other down-to-earth techniques of managerial control. Indeed, a notable development in the literature on preventive law is the use of risk management theory to generate highly practical guides for decision making.

Warning Systems

Another infamous area of neglect is the need for warning systems to help ensure that management is alerted to compliance problems which threaten the company. There are numerous examples of compliance problems being concealed at lower or middle levels of management and of companies being taken by surprise when the bad news leaks to the public (eg. Exxon in relation to allegations of the payment of bribes by its Italian subsidiary). The solution adopted by many companies (eg. General Electric, Exxon, and United Airlines) has been to supplement one-over-one reporting relationships with extra reporting channels to top management.

The best advice for avoiding communication blockages can be summed up in these terms:

● Make sure that routine formal reporting relationships are designed well and appropriately enough to the unique environment of the company, to ensure that most recurrent problems of non-compliance are reported to those with the power to correct them.

● Make sure there is a free route to the top, by-passing line reporting relationships, to reduce the likely success of conspiratorial blocking of bad news.

● Create a corporate culture with a climate of concern for compliance problems which are not an employee's own responsibility — an organisation "full of antennae" in which there is a commitment to being alert to noticing and reporting how others, as well as oneself, can solve compliance problems.

Training and Supervision for Compliance

It is not enough for top management to know when non-compliance is occurring and then to tell those with clearly defined responsibility for the problem to bring the company into compliance. Often, the problems are complex, so formal and systematic training is needed to ensure that all employees know how to comply in their area of responsibility, and supervision is needed to ensure that the lessons of the training have been learnt.

Thus, all legal and marketing personnel require training in restrictive trade practices, and industrial relations staff training in labour relations law. All production people need occupational health and safety training. The mistake which many non-compliant companies make is in communicating the relevant knowledge to middle management and then glibly assuming that they will pass it down.

The five coal mine safety leaders were all characterised by extraordinary measures to ensure that first-line supervisors were training and supervising their workers. At US Steel, for example, department heads are responsible for developing training plans which ensure that foremen provide all workers with training in a set of safe job procedures which are written by the foreman

for the job of each employee in his care. Each foreman must make at least one individual contact each week with each employee under his supervision to consolidate this training. With inexperienced workers, these contacts are usually "tell-show" checks, whereby the worker is asked to explain what should and should not be done and why the approved procedure is the safest one.

Foremen are required to make at least two planned safety observations of each employee each month. The safety observations are planned so that they cover systematically all job operations for which the employee has received instruction. In addition to the safety observations, which are planned and scheduled at the beginning of each week, foremen are expected to perform additional "impromptu observations" following chance recognition of unsafe practices. Whenever a foreman observes an unsafe condition or work method, whether in a planned or impromptu safety observation, he must correct it immediately and report the occurrence to higher management on a "supervisor's safety report". The foreman can tell whether a worker who deviates from a procedure or rule has been trained in it by looking at the employee's record. For all employees, a record is maintained by their foreman, noting their safety history — basic training, safety contacts, planned safety observations, unsafe acts, violations, discipline and injuries. When workers move from foreman to foreman, their records move with them, so a new foreman can discover at a glance what safety training a worker lacks for his new job.

In short, effectively self-regulating companies do not tell middle managers how to comply and assume they will tell the troops; they have training policies and programmes to guarantee that training is happening and working down to the lowest reaches of the organisation. They audit compliance with compliance training programmes as assiduously as they audit compliance itself.

Watching Pressures for Non-compliance

Having covered the five basic principles for creating an effectively self-regulating company, consideration might be given to another even more basic principle. This is that companies must be concerned not to put employees under so much pressure to achieve the economic goals of the organisation that they cut corners with the law. The role of excessive performance pressures on middle managers in creating corporate crime has been frequently pointed to in the literature[5]. Corporate Crime in the Pharmaceutical Industry[2] illustrated the problem thus:

Take the situation of Riker, a pharmaceutical subsidiary of the 3M corporation. In order to foster innovation, 3M imposes on Riker a goal that each year 25 per cent of gross sales should be of products introduced in the last five years. Now if Riker's research division were to have a long dry spell through no fault of its own, but because all of its compounds had turned out to have toxic effects, the organisation would be under pressure to churn something out to meet the goal imposed by headquarters. Riker would not have to yield to this pressure. It could presumably go to 3M and explain the reasons for its run of bad luck. The fact that such goal requirements do put research directors under pressure was well illustrated by one American executive who explained that research directors often forestall criticism of long dry spells by spreading out discoveries — scheduling the programme so that something new is always on the horizon.

Sometimes the goal performance criterion which creates pressure for fraud/bias is not for the production of a certain number of winners but simply for completing a predetermined number of evaluations in a given year. One medical director told me that one of his staff had run ten trials which showed a drug to be clear on a certain test, then fabricated data on the remaining 90 trials to show the same result. The fraud had been perpetrated by a scientist who was falling behind in his work-load and who had an obligation to complete a certain number of evaluations for the year (p. 941).

One might say that this is an inevitable problem for any company that is serious about setting its people performance goals. But there are differences in the degrees of seriousness of the problem. At one extreme are companies which calculatedly set their managers goals that they know can only be achieved by breaking the law. Thus, the pharmaceutical chief executive may tell her regional medical director to do whatever he has to do to get a product approved for marketing in a Latin American country, when she knows this will mean paying a bribe. Likewise, the coal mining executive may tell his mine manager to cut costs when he knows this will mean cutting corners on safety.

The mentality of "do what you have to do but don't tell me how you do it" is widespread in business. Eliminating it is easy for executives who are prepared to set targets which are achievable in a responsible way. It is a question of top management's attitudes. IBM is one example of a company which we found to have the approach to target setting which we have in mind. IBM representatives have a sales quota to meet. There is what is called a "100 Per Cent Club" of representatives who have achieved 100 per cent or more of their quota. A majority of representatives make the 100 Per Cent Club, so the quotas are achievable by ethical sales practices. IBM, in fact, has a policy of ensuring that targets are attainable by legal means. Accordingly, quotas are adjusted downwards when times are bad.

As Clinard found, unreasonable pressure on middle managers comes from the top, and most top managers have a fairly clear idea of how hard they can squeeze without creating a criminogenic organisation[5 pp. 91-102, 140-4]. In the words of C.F. Luce, Chairman of Consolidated Edison: "The top manager has a duty not to push so hard that middle managers are pushed to unethical compromises"[5 p. 142].

This "duty", however, takes us back to the fundamental problem of self-regulation. Companies must have a desire to comply with the law sufficiently strongly to let this override other corporate goals. This sixth "principle" therefore really reduces to companies being motivated to be effectively self-regulating. We believe companies can be so motivated from their internal deliberations as moral agents, from their self-interested concerns to minimise risks, but, more importantly, from external pressures calculated to make effective self-regulation an attractive policy. The design of these external pressures is a topic for another day.

References

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AUDITING TH[E] STATION: PAR[T] THE PROBLE[M]

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Introduction

Every day in offices, shops and factories, [...] jobs. They call them VDUs, CRTs, or just p[...] a keyboard and a link to a central proces[...] According to a Pender Associates survey, t[...] are in use today. And every one of them [...]

The Ergonomics Approach

The millions who use these work stations gene[...] know very little about how the system works, what g[...] on behind the screen, or where their input goes[...] workers even think about these things. Few mana[...] think about them either. They rely on the knowle[...] that their system has been designed by experts to [...] highest ergonomic standards. In most cases, this [...] is misplaced.

Ergonomics is a well-established science conce[...] with measuring and meeting the biological, physical [...] mental needs of workers. In particular, ergono[...] examines the relationship between these needs and [...] design of the tools provided for the job. Its major f[...] is on the man/machine interface, and tries to de[...] machines which will simultaneously combine wo[...] satisfaction, health and safety, and productivity.

The recent introduction of computer-ba[...] technologies has revitalised ergonomics, bringing [...] opportunities but also exposing some limitation [...] traditional practice. Less emphasis is now place[...] purely mechanical considerations, more attentio[...] given to specific computer issues such as screen [...] interaction and "software psychology", the behavi[...] factors inherent in software production. The desi[...] modern work stations fully reflects the latest disco[...] and ideas in ergonomics. They are stylish, quiet [...] easy to use.

However, this is not enough. Walk through any [...] office, and you will almost certainly find that ma[...] machine design principles have not delivered prot[...] free systems.

The reason for this is not hard to find. In the past, [...] station design effort has been centred on providing [...] effective systems, concentrating on cost of equip[...] and technical merit. These design priorities have p[...]