

PREEMPTING THE RISK OF COMPLIANCE FAILURES: FIVE LEADING INDICATORS OF MISCONDUCT

This brief summarizes key findings of a recent Compliance and Ethics Leadership Council study about leading indicators of misconduct. These findings will help CFOs target their risk management efforts, beyond the typical investments in compliance controls, and ultimately reduce the risk of compliance failures.

To identify the true drivers of misconduct, the most prevalent types of misconduct observed by employees, and the prevalence of misconduct among various employee groups, the Council surveyed nearly 1,800 employees at leading global organizations. In the course of this study the Council also estimated the financial and legal costs of unreported misconduct—nearly a third of managers report observing misconduct that could have a significant financial impact on their company, up to 5% of companies' annual revenues. The Council's survey identified elevated levels of observed misconduct across twelve categories (Figure 1), including harassment and theft, which are contributing to these rising costs.

Identifying the Leading Indicators of Misconduct

Many companies that seek to reduce misconduct simply do not know where to begin. Compliance officers currently rely on a diverse mix of information sources, ranging from internal audit findings, industry trends, and employee surveys. Unfortunately, most of this information is comprised of lagging indicators, and only 7% of companies take a holistic approach to analyze multiple data sources, including company culture and other

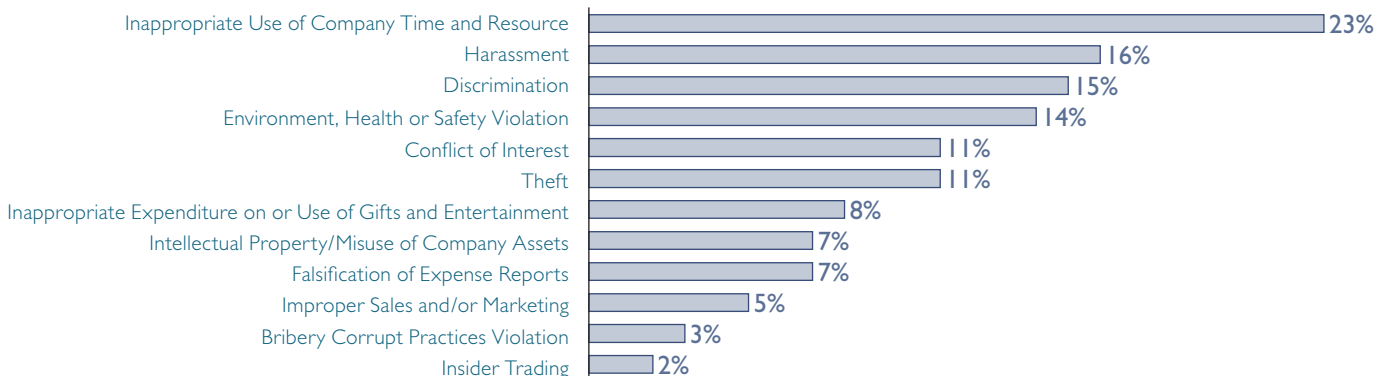
predictive metrics.* To help senior executives tackle this issue, the Compliance and Ethics Leadership Council identified 45 factors that drive employee misconduct and conducted statistical analysis to identify the vital few factors that are predictive of misconduct (Figure 2). The following five indicators collectively predict approximately 20% of the difference in the observed increases in misconduct at a company:

The Top Five Leading Indicators of Misconduct

- 1) A Culture of Retaliation, and Discomfort Raising Concerns
- 2) Colleagues Willing to Compromise Values for Power and Control
- 3) Direct Managers Lack Trust In and Respect for Employees
- 4) Higher Percentage of Variable Compensation
- 5) Commitment to Job Greater than Commitment to Company

Observed Misconduct, by Misconduct Type

Percentage of Employees Observing Misconduct



n = 1,800.

* Predictive metrics include leadership changes, staff turnover, planned business initiatives, financial results.

Source: Compliance and Ethics Leadership Roundtable; CFO Executive Board research.

Identifying the Leading Indicators of Misconduct

The Compliance and Ethics Leadership Council’s research makes the following recommendations about the top leading indicators of misconduct:

1. To reduce the fear of retaliation for reporting misconduct, clarify ethics rules and accountability.

Research indicates that the fear of retaliation about speaking up is the most predictive factor of the likelihood of misconduct. Council’s research identified the following organizational indicators of a retaliatory culture:

- Unclear expectations and disciplinary guidelines
- Lack of concern and empathy for fellow colleagues
- Unresponsiveness and lack of accountability among senior executives to inappropriate behavior
- Compliance and integrity training lacks applicability

This fear contributes to the hidden costs of fraud and misconduct—senior executives do not report misconduct more than half the time, and line employees do not report 85% of the misconduct that they observe. These statistics send a critical message to CFOs and other senior leaders: companies must first and foremost ensure that employees have a clear sense of how issues will be handled and create an environment where employees are not afraid to report misconduct.

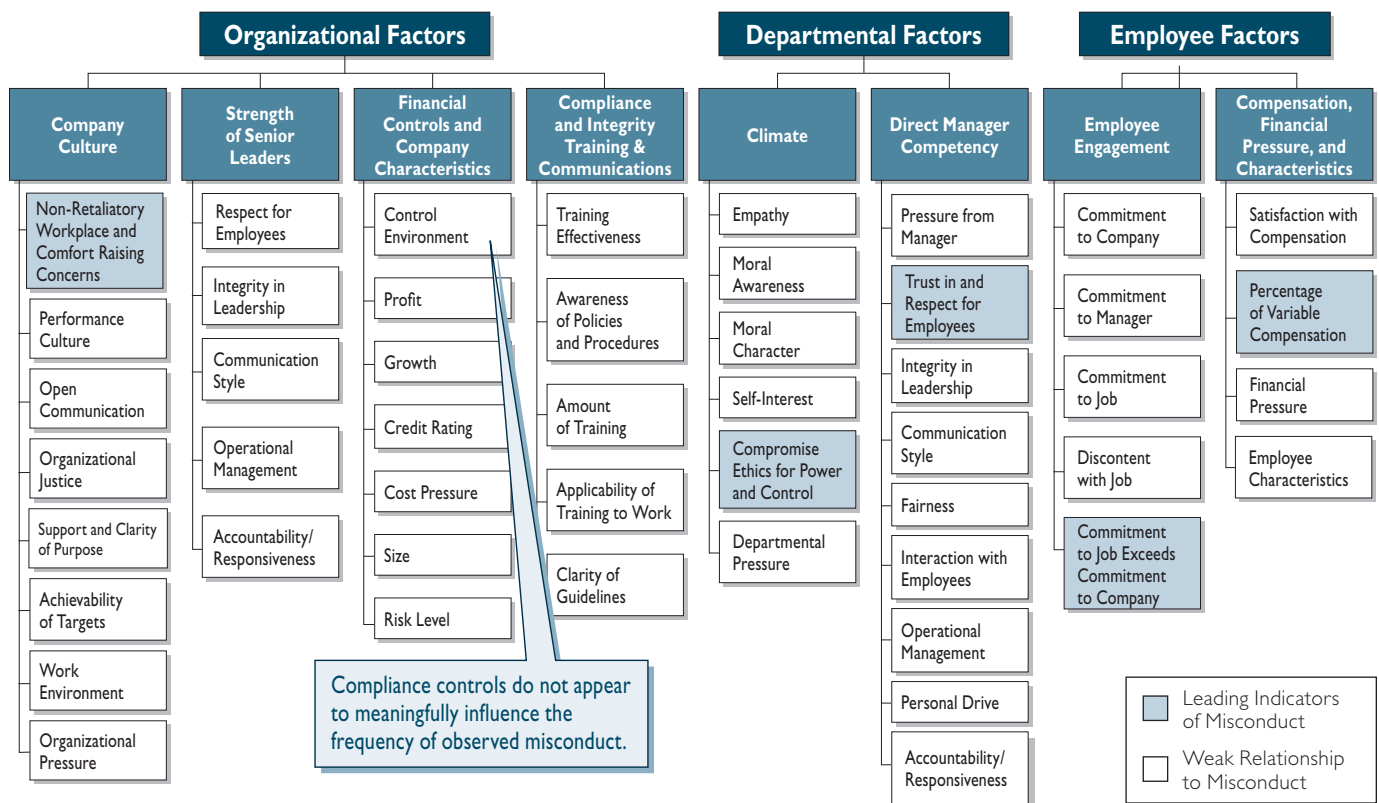
2. Watch out for opportunities where employees can compromise ethics for personal gain.

Employees who are seeking power and success are most susceptible to temptations, but senior executives are only half as likely to be influenced by this factor as middle managers, and non-management staff.

3. Do not automatically assume that high-performing managers also create a positive ethics environment.

The quality of employees’ interaction with managers has a significant impact on the likelihood of misconduct. In this instance, poor managerial quality is defined by a lack of respect and trust in employees, and excludes other characteristics that are commonly used to define poor managers, i.e., weak reputation, low encouragement of employee development and weak project management skills. It should not be surprising, therefore, that a high-performing manager from a financial or operational results perspective can actually be a low-performing manager from a compliance perspective. Companies must use a non-traditional lens to evaluate ethics-related manager quality.

Figure 2: Potential Drivers of Misconduct



Source: Compliance and Ethics Leadership Roundtable; CFO Executive Board research.

Identifying the Leading Indicators of Misconduct

4. High proportions of variable pay correlate with misconduct.

While senior executives are not as affected by the drive to gain power and control in the organization, higher levels of variable compensation* does seem to correlate with higher levels of misconduct among senior executives. For example, when a significant portion of management’s compensation is comprised of bonuses or other incentives, the value of which is dependent on meeting aggressive earnings targets, the operating environment creates higher potential for executive-level fraud and abuse.

5. Encourage commitment to the company, not merely the job, to help employees avoid decisions that could potentially compromise enterprise health.

It is widely believed that increased levels of commitment to manager, company, and the job are associated with decreased misconduct among employees. However, the ratio of an employee’s commitment to company and commitment to the job can often pose an issue—those who are more committed to their job than the company can be more susceptible to misconduct. For example, employees who fail to follow customer service or third-party vendor management guidelines in order to achieve their objectives faster or more easily could be succeeding in their roles despite an overall negative impact on the company’s brand or reputation. Therefore, companies should be cautious about focusing solely on an employee’s engagement to his/her job and should instead encourage commitment to the goals and values of the company.

Demystifying the Poor Indicators of Misconduct

The Compliance and Ethics Leadership Council’s survey also uncovered a series of commonly used indicators of fraud, which are actually weak—some of them matter in an indirect way and others carry no significance at all. The full list of the poor indicators is illustrated in Figure 2 (page 2). CFOs will be especially interested to learn that one factor that did not make the top five list was compliance controls. Compliance controls is an area of significant investment for many companies but

appears to have limited influence on observed misconduct levels. Also, contextual factors that are difficult for executives to change such as industry, size and financial distress are also not statistically significant indicators of misconduct. Lastly, employee characteristics also seem have no direct impact on the likelihood of misconduct; as such, profiling individuals using age, gender and racial characteristics is unlikely to be effective in predicting misconduct.

Financial and Controls-Related Indicators That Are Weak Indicators of Misconduct

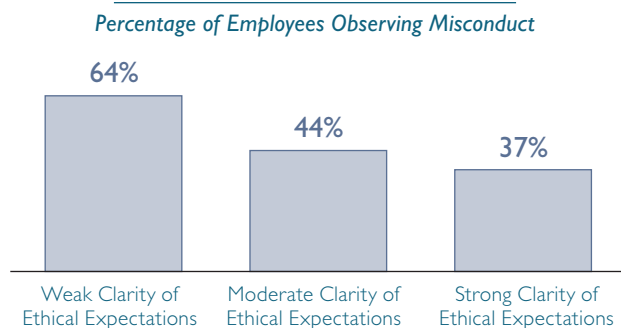
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| 1) Weak compliance controls | 3) Growth pressures | 5) Cost pressures | 7) Financial and operating risk levels |
| 2) Profit pressures | 4) Poor credit rating | 6) Size of company | |

In Conclusion

The leading indicators of misconduct are addressable and squarely within the control of senior executives. The Compliance and Ethics Leadership Council is currently undertaking an extensive research inquiry into the practices and tools used by leading companies to minimize employees’ fear of retaliation and to build a “performance-with-integrity” culture.

Early findings indicate the most important step senior executives can take in this area is simply to communicate ethical expectations more clearly to employees. Improving clarity of expectations and disciplinary guidelines can reduce misconduct levels by more than 40% (Figure 3).

Figure 3: Misconduct Levels by Clarity of Ethical Expectations at Company



n = 1,800.

* Bonuses, options and other incentive play.

FOR MORE INFORMATION

Click [here](#) to download a copy of the Executive Summary of “Quantitative Insights into the Drivers of Business Misconduct.”

To learn more about the Compliance and Ethics Leadership Council, please contact us at CELCweb@executiveboard.com.

Source: Compliance and Ethics Leadership Roundtable; CFO Executive Board research.

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