Compliance in Manufacturing: A Very Personal Affair

Noncompliance can ruin corporate reputations, shatter financial performance, and destroy careers, families, and lives. With so much to lose, doesn’t compliance deserve our undivided attention?
“Every company is just one bad decision or one ‘bad employee’ away from scandal, one scandal away from a salacious headline, and one headline away from a flood of lawsuits.”

This quote from William Lytton, former executive vice president and general counsel of Tyco International, reminds business of its vulnerabilities. Corporate compliance—or, more accurately, the risk of noncompliance—has become a major concern over the past decade, especially for global manufacturers with operations in many different countries and jurisdictions. When a practice commonly accepted in one country could be a serious criminal or civil offense in another, companies had better know about it.

Consider, for example, the billions of dollars in fines a German conglomerate paid for its improper approach to winning contracts, or the now infamous 2010 Deepwater Horizon oil rig explosion in the Gulf of Mexico that ended in a record $4 billion in criminal fines and penalties.

Violations can also have personal repercussions, as compliance is often a top-management issue, with board members legally responsible for creating a system that guarantees adherence to all regulations.¹ In 2011, a major camera and medical equipment maker and three of its former executives pleaded guilty to inflating the company’s net worth in financial statements. On top of huge corporate fines, the courts could still hand down 10-year jail sentences and fines of up to $128,000 for the former executives.

And today’s regulatory pressure doesn’t stop with external authorities. Many firms understand that compliance can lead to competitive advantage and are making their suppliers commit to compliance standards that go far beyond those required by law.

To understand how companies reduce the risks of noncompliance, A.T. Kearney surveyed executives at leading manufacturers, conducting in-depth interviews with compliance executives at nearly 40 top companies worldwide (see sidebar: About the Study). While most studies approach compliance from a legal perspective, we focus our attention on compliance management.

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¹ Most jurisdictions explicitly regulate personal responsibility of corporate management. In Germany, section 130 of the Ordnungswidrigkeitengesetz (OWiG), the Administrative Offenses Act, holds board members liable for dereliction of their supervisory duties. In the United States, the Federal Sentencing Guidelines establish personal responsibility for certain types of corporate misconduct.

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About the Study

A.T. Kearney conducted the Excellence in Compliance in the Manufacturing Industry study to provide insights on how companies can avoid financial and reputational damage caused by noncompliant behavior.

To develop the key success factors for a high-quality compliance framework, we surveyed compliance experts, compliance officers, and the compliance department staff of nearly 40 leading manufacturers, representing a wide range of industry types and company sizes (see figure). Empirical findings, expert opinions, and our experience with worldwide clients satisfy us that the study’s conclusions and framework are applicable across industries and global regions.

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Figure

Participants by company size

Number of employees

Source: A.T. Kearney analysis
Major Findings

We centered our analysis on the eight main compliance areas (see figure 1). Product safety and health, safety, and environment (HSE) are the most well-known and widely investigated, while anti-corruption and data protection are relatively new to the compliance discussion. Other areas include IT safety and security, employment law, fair competition, and export controls.

Figure 1

Eight main areas of compliance

- Product safety
- Health, safety, and environment
- Anti-corruption
- Data protection
- IT safety and security
- Employment law
- Fair competition
- Export controls

Source: A.T. Kearney analysis

Five major findings emerged from our examination of compliance management in these areas:

- **Most companies expect to expand their compliance systems.** Furthermore, 57 percent of the compliance experts say they will most likely seek external help, especially to staff departments with experts in anti-corruption, data protection, and product safety issues.

- **Lower management has a much less favorable perception of compliance systems than top management.** This indicates a strong need for administrative efforts to generate acceptance at all management levels to ensure that compliance systems are effectively implemented and operated.

- **Most companies do not have an independent compliance department** that reports directly to the executive board.

- **External resources are especially useful for setting up a compliance system.** This way, administrative staff is not tied up implementing the system—while day-to-day business activities languish—and there is less risk that the system will be over-engineered. Providing resources and vital knowledge, these outside experts help build a lean and independent compliance system that ensures rapid effectiveness and long-term efficiency.

- **The most effective compliance systems integrate compliance and process management.** This establishes a solid foundation for a successful, organization-wide system.
In light of these findings, this paper examines three areas where executives expect to see a rise in incidents, sheds light on the importance of putting compliance management into practice, and discusses how to allocate resources. We also outline where to position the compliance department within the organization and, finally, introduce our compliance framework, a best-practice approach to building an effective compliance system.

Compliance in the Spotlight

Most study participants expect to see a rise in the number of compliance incidents in three areas—anti-corruption, product safety, and data protection—and plan to invest in external support to counter the associated risks (see figure 2). Interestingly, these areas correlate with high-profile media coverage of recent compliance breaches, such as those cited above. The more prosecutors and the media become interested in compliance, the more likely seemingly small incidents may evolve into epic disasters. An ever-more complex web of regulations and the growing number of companies operating in multiple jurisdictions will add to the increase in compliance incidents.

Figure 2
Future areas of focus in compliance

These three areas require specific skill sets during implementation of a compliance system. For example, most processes to ensure compliance with anti-corruption legislation must be developed from scratch, while product safety compliance requires deep legal knowledge, especially regarding cross-border standards. At the same time, data protection relies on sophisticated IT systems that require specific technical support.
As severe fines and even prison sentences loom for those found guilty of noncompliance, personal liability has become the biggest motivator for top management to invest in compliance systems, followed by corporate fines, customer requirements, and ethical commitments (see figure 3). While management mistakes in other areas often force executives to change companies or industries, there is a strong feeling among experts that any involvement in compliance issues has the power to terminate careers. Three other goals motivate companies to build effective compliance systems:

- **Fulfill the requirements to stay in business**, including a basic system that ensures adherence to minimal standards, such as providing a designated HSE officer
- **Avoid direct consequences** in the form of fines or loss of business resulting from obvious compliance violations
- **Strive for excellence** and stay ahead of the competition by delivering top compliance track records and pushing a clean brand image

![Figure 3](image)

**Concerns that lead to increased investment in compliance systems**

**Main reasons to expand the compliance system**

( as % of answers)

- **Personal liability** 63%
- **Corporate fines** 59%
- **Customer requirements** 47%
- **Ethical commitments** 47%
- **Competitive advantage** 41%
- **Regulatory pressure** 38%

**Avoid direct consequences**
- Fines
- Loss of business through exclusion from tenders

**Avoid indirect consequences**
- Failure to fulfill minimum customer standards
- Brand devaluation

**Meet basic requirements**
- Adherence to minimal standards
- Obtainment of business license

Note: Multiple answers possible
Source: A.T. Kearney analysis

Of the compliance executives in our survey, 47 percent say that North America has the strictest regulations, while 25 percent cite the European Union. Nine percent name other regions as having the most demanding compliance standards, and 19 percent see no significant differences among regions. The upshot: Companies expanding into new regions should be prepared to face considerable compliance risks, especially in North America.
Compliance in Practice

If top management fails to create an environment that ensures compliance—or lacks documentation to prove all necessary steps have been taken—it can be held accountable for compliance breaches. With this in mind, compliance must be an inherent part of day-to-day business, fully embedded in the organization. Employee involvement and acceptance, including a complete understanding of requirements and objectives, are integral aspects of a solid compliance system, say 78 percent of the executives we surveyed.

Management, then, must find practical ways to ensure that employees understand and comply with the relevant laws. This includes translating corporate business ethics into practical work instructions. A successful compliance system is also integrated into processes and has both sufficient resources and management buy-in.

The most important factor for maintaining a compliance system is creating acceptance on all levels. While top management typically acknowledges the need for a compliance system, with 68 percent of top managers expressing a “positive” perception of such a system, these levels drop sharply to just 19 percent among lower management. A top-down approach seems to be the chief culprit for this phenomenon.

Although 83 percent of companies conduct training to improve awareness, only 23 percent offer incentives to reward positive conduct, and just 8 percent use powerful interactive techniques such as role playing. As compliance penetrates all functional areas, having key personnel as role models is just as important as supplying specifically trained compliance personnel. As for top management, uncompromising adherence to regulations is essential.

Integrating compliance into processes

From a technical standpoint, integrating compliance into business processes—cited by 70 percent of respondents as a major contributor to successful implementation—is difficult but not impossible. We recommend a three-step approach (see figure 4).

Figure 4
Three stages of integrating compliance into process management

1. Define processes and responsibilities

   - Design processes
     - Govern adherence to regulations with processes
     - Assign clear responsibilities to process managers

   - Link regulations to processes
     - Involve internal and external legal experts
     - Solve trade-off between administrative overload and risk mitigation

   - Set up a control system
     - Take measures to mitigate noncompliance in critical processes
     - Document all measures and delegation paths

Source: A.T. Kearney analysis
• **Design processes.** All standard business processes are designed with compliance management in mind. This includes establishing risk-mitigation measures, assigning tasks and responsibilities (such as an HSE officer), and defining company-wide procedures. Often, it is necessary to establish explicit approval thresholds, systematically check that specific prohibited items are not traded with embargoed destinations, and define protocols for dealing with cash flow above a certain amount.

• **Link regulations to processes.** Specific duties, such as handling hazardous substances, are always integrated into existing business processes. This often requires close cooperation with lawyers, subject-matter experts, and quality and process managers. Preferably, all relevant duties are performed with a minimum of administrative effort, since overburdening production personnel can be detrimental to system effectiveness.

To create full transparency while remaining lean, process integration should encompass four areas:

— Connect regulation and adequate manuals of adherence to processes
— Lay out and regularly update delegation paths and responsibilities
— Install an automated signoff procedure that reflects the understanding of personal duties

• **Set up a control system.** Finally, processes with the greatest risk of noncompliance are connected to an internal control system. The system includes control points that are checked regularly, either manually or automatically. The scope of control can range from a simple check using the “four-eyes” principle to the full review of outgoing cash flow. An essential part of the system is the central documentation of all control activities undertaken to reveal compliance breaches, reevaluate risk areas, and provide the basis for continuous improvement.

### Allocating Resources

A compliance system’s resource requirements are highest during the implementation phase, when new standards and procedures must be aligned with existing processes, and then decrease once the system is operational (see figure 5 on page 8). An overly large compliance department can have a negative impact on business activity because of extensive bureaucracy—a situation that nearly 20 percent of our study respondents say happened in their companies.

External resources can mitigate this risk by temporarily providing the required capacity and experience for implementation, while avoiding the pitfall of an excessively large compliance organization that can create unnecessary tasks simply to justify its bloated size once operations become stable.

### Positioning the Compliance Department

While 89 percent of our respondents say they have established some kind of compliance system, less than half (41 percent) have formed an independent compliance department. Nearly one-third say that their legal department is responsible for compliance.
Integrating compliance into other departments, as opposed to making it a standalone department, can lead to contradictory objectives. If the legal department is charged with compliance, for example, conflicts can arise between the obligation to create transparency and the duty to immediately contain the damage of a violation. Such integration can also place too much emphasis on the theoretical legal aspects of compliance and not enough on the management aspects, which often means compliance is not sufficiently embedded into business processes.

Our compliance framework shields executives and board members from personal consequences of breaches and helps prevent and detect such issues before they cause damage.

Properly run, an independent compliance department can maintain close—and more neutral—interfaces with all involved departments (legal, quality, and internal audit), while ensuring that expert input and knowledge is transferred among compliance areas. We also recommend a direct reporting line to the executive board, both to secure adequate resources and to demonstrate that compliance is a top priority.
A.T. Kearney’s Compliance Framework

Our best-practice approach to building a compliance system incorporates the previously discussed factors, along with lessons learned from our work with companies worldwide. The result is the compliance framework shown in figure 6. The framework is designed to not only shield executives and board members from potential personal consequences of compliance breaches, but also to prevent and detect them before they cause damage.

Figure 6

A.T. Kearney’s compliance framework

Governance
- Define reporting structure that guarantees compliance group’s neutrality and effectiveness
- Develop encompassing system with interfaces to all relevant functions

Processes
- Embed compliance in process management
- Create process to govern major risk areas
- Connect regulations to process steps; connect critical processes to internal control system

Buy-in
- Provide training to ensure acceptance at all levels
- Communicate top management buy-in (role models) and provide continual guidance

Resources
- Define resource levels based on compliance risks per process and “heat map” of improvement areas
- Consider use of external resources, particularly during implementation

Governance forms the framework’s roof, overarching a compliance department that combines neutrality, efficiency, and effectiveness to ensure company-wide acceptance of delegated duties and to help avoid inefficiencies arising from the often conflicting goals of total compliance and lean processes. The framework’s foundation is its resources, which are allocated to areas that are most vulnerable (identified through a risk assessment). The main body of the framework—its interconnecting walls—consists of integrating processes and getting buy-in, following the principles of prevention, detection, and reaction.

In all compliance areas, processes are linked to relevant regulations and to the internal control system. These processes aim to prevent compliance problems as much as they seek to provide a transparent way to monitor adherence. Through documentation, it is possible to constantly readjust risk mitigation efforts, update processes, and redefine responsibilities to better address actual compliance gaps. The central information pool is used to continually improve processes and can serve as a repository of evidence for the efforts the company and its management have taken to comply.

Even the most sophisticated system is worthless without acceptance and cooperation. Changing management methods, for example by increasing personal contact with key personnel, can be just as important as training, workshops, and control-system updates. Toward this end, executive boards must lead by example and actively support all compliance department initiatives.
Complying for Competitive Advantage

An effective compliance system is vital to being competitive in markets that demand adherence to regulations that are likely to get even tighter in the future. The best systems have sound governance, documented processes, and clearly delegated responsibilities—sheltering the entire company from compliance breaches and their consequences. As executives at many companies have learned in recent years, noncompliance can become very personal.

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A.T. Kearney is a global team of forward-thinking, collaborative partners that delivers immediate, meaningful results and long-term transformative advantage to clients. Since 1926, we have been trusted advisors on CEO-agenda issues to the world's leading organizations across all major industries and sectors. A.T. Kearney's offices are located in major business centers in 39 countries.

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