Compliance Management – a New Response to Legal and Business Challenges

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Abstract: Accounting failures at Enron and others have raised the question of adequate internal controls. The current global economic crisis has increased the public and legislative focus on accountability, transparency, risk management and compliance with laws and regulations. Organizations seek efficient and effective mechanisms to ensure keeping up with challenging legal requirements. This paper will facilitate the understanding of how corporations can improve their compliance by the setup of a compliance program (including design, implementation and evaluation). Basic compliance initiatives prevent legal misbehavior, complex programs extend to areas like customer satisfaction, public reputation, transparency, ethical behavior, organizational structure and risk management. Compliance in practice is a complex issue that requires interdisciplinary research since it lies on the borderline of law, finance, risk management and operations management. This paper proposes a variety of compliance related research hypothesis.

Keywords: compliance management; compliance function; compliance and ethics; risk management

1 Introduction

Dramatic incidents of excessive greed, accounting failures or conflicts of interest, including those of Enron, Parmalat, WorldCom, Citigroup, Arthur Andersen and more have raised the question of adequate internal controls. In the last 20 years accountability, transparency, risk management and compliance with laws and regulations have become highlighted issues.

Basic compliance initiatives prevent legal misbehavior, but complex programs extend to areas like employee morale, customer satisfaction and public reputation. Compliance management is embedded into the present trends of ethical awareness, corporate environmental and social responsibility and public commitment.

The current global economic crisis has increased the public and legislative focus on risk management and risk prevention. Today, in Hungary we face an ever-changing regulatory environment. As a reaction to this, organizations seek efficient and effective mechanisms to ensure they can keep up with challenging legal requirements. Compliance efforts range from ad hoc projects to mature and complex programs. Along the way, we have witnessed the birth of a profession and the growth of its supporting industry, including consultants and suppliers [1].

This article is composed of four parts. First, an overview of compliance management is given, including the overview of SoX requirements, the COSO framework and the FSGO standards. In the second part, compliance is discussed as an organizational function. Strategies, actions and resources for managing compliance in organizations are detailed. Later, working hypothesis are listed for possible future research to find out the state of compliance function in highly regulated industries in Hungary. Finally, conclusions and challenges are outlined.

2 What is Compliance Management

The aim of compliance management is to detect and prevent corporate crimes and mistakes, minimize the damage of arising issues, prevent recurrence, improve business and control processes. Ideally, compliance management helps people on all levels to operate an organization without discovered or undiscovered non-compliance incidents.

The scope of compliance management varies from one corporation to the other. Under the umbrella of compliance management it may include compliance to business related laws and inner regulations, environmental issues, labor and wage regulations, data security, health and safety issues, equal employment opportunity, antitrust considerations and competition, fund raising, etc. There is a risk that compliance initiatives address too many areas but bring fewer results than a strictly defined scope. Financial compliance is usually managed by auditors. Operational compliance used to be managed by several professionals, for example lawyers, internal control specialists and strategy consultants. These days, compliance officers are in charge.

Though the state is the main source of regulations, compliance management deals with other forms of regulations as well, such as internal corporate policies, professional groups (e.g. the Basel Committee), industry associations, etc. Compliance management can be seen as part of a shift from regulatory law enforcement to self-regulation. "Self-regulation can be often more prompt, flexible, and effective than government regulation. It can permit application of the accumulated judgment and experience of an industry to issues that are sometimes difficult for the government to define with bright line rules" [2], ISO certification is a classic example of self-regulation. We must note that government incentives

to certified economic actors are a driving force. Proponents of self-regulation point out the lower costs to produce the same protection.

The disadvantages of self-regulation can be weaker enforcement (see Box 1) and the phenomenon also described as the regulatory paradox, namely violators avoiding registration into self-regulating organizations. Furthermore, voluntary codes could be developed in accordance with or rather against government initiatives.

Executive compensation used to be regarded as the company's very private, internal affair. However, the outrageous remuneration incidents of listed companies in the US and the EU (e.g. Bank of America) have attracted public attention to the problem. In the EU, the 2004/913/EC [3] recommendation created a general regulatory framework. The overall influence of the non-binding recommendation was not powerful enough. Following the financial crises of 2007-2008, a risk-based review of the bonus structure was vital [4]. The general requirement of the Financial Services Authority Code is, "A firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management." [5] In 2010, the third Capital Requirements Directive (CRD3) amendments were approved, including the regulation of the structure, amount and timing of bonus payment in financial institutions (i.e.: immediate bonus payment cannot exceed 60%; at least half of the bonuses should be paid in shares, etc.). Member states were required to implement CRD3 by the end of 2011. This is a current example of a recommendation turning to hard law.

For many corporations, a risk-based redesign of the overall corporate remuneration system is a future challenge. For instance, one main task of banks is to carefully control risks taken. But agent-principal situations imply some moral hazard: renumeration can encourage risky lending and a focus on short-term results. Incentive systems should be adapted to the nature of the product; a long-term product should be connected with long-term interests (mixing immediate and deferred bonus payments). Clear rules on the remuneration of intermediaries could promote higher credibility, transparency and stability.

Box 1
Example of regulatory shift from the concept of self-regulation to hard law

As for self-regulation in the matter of compliance management, the seven elements of the Federal Sentencing Guidelines for Organizations (FSGO) form the basis of understanding and managing compliance risks for businesses in the USA. These guidelines help organizations to plan and implement programs that help facilitate compliance, identify and sanction noncompliance, and are viewed as effective by the courts. "A company may, under some circumstances, receive a more lenient sentence if it has in place an effective compliance and ethics program." [6] According to Silverman, the FSGO components are the following:

1 "Organizations must establish compliance standards and procedures to be followed by employees and agents of the organization.
2 The program must be administered and overseen by 'high-level' personnel within the organization.

3 Organizations must ensure that substantial discretionary authority is not delegated to employees with a propensity toward criminal conduct.
4 Organizations must provide training programs and effective communications about their compliance standards and procedures.
5 Monitoring and auditing systems must be implemented, and a reporting system must be established through which employees can report wrongdoing without fear of retribution (e.g. whistle-blowing programs).
6 Organizations must provide incentives for employees and others to come forward to report issues and must establish disciplinary policies for those involved in wrongdoing.
7 After an offense has been reported, organizations must take reasonable measures to respond and prevent future incidents from occurring." [7]

The original FSGO was revised in 2004. The amendments focused on the proactive role of leadership and included ethics, as standards for an "effective compliance and ethics program".

In 2002, the Sarbanes-Oxley Act (SoX) was passed. This law has set new standards of financial reporting, auditing and internal governance for publicly traded companies. "The legislation required the organization's chief executive officer (CEO) and chief financial officer (CFO) to certify not only the completeness and accuracy of the information contained in quarterly and annual finance reports, but also the effectiveness of the underlying internal controls that generated the information" [8]. The most far-reaching part of the act is Section 404, which requires companies to include an internal control report into the annual financial reports. Section 406 requires a disclosure on the code of ethics for financial and accounting officers. Since SoX, organizations must set, monitor and assess their internal controls to inform the public investors, the CEO and CFO have enhanced responsibilities for the behavior of the corporation. The underlying principle of the act is that communication of achievements and defects can support public trust in the corporate sector.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a voluntary organization formed by several professional groups. The 1992 COSO Internal Control – Integrated Framework is qualified as a suitable assessment framework for SoX control assessment. COSO has been stated to have met the Securities and Exchange Committee's four criteria:

1 "Be free from bias.
2 Permit reasonably consistent qualitative and quantitative measurements of a company's internal control.
3 Be sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of a company's internal controls are not omitted.
4 Be relevant to an evaluation of internal control over financial reporting." [9]

The COSO framework report gives a definition of internal control: "a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

1 Effectiveness and efficiency of operations.
2 Reliability of financial reporting.
3 Compliance with applicable laws and regulations." [10]

It also describes five interrelated components of internal control (see Figure 1), all relevant to each above mentioned objectives category:

1 The **control environment** is the foundation for all other components of internal control. "An effective control environment is an environment where competent people understand their responsibilities, the limits to their authority, and … are committed to following an organization's policies and procedures and its ethical and behavioral standards." [11] Factors of control environment are: the management's operating style, direction provided by the board, ethical values maintained and demonstrated, etc.
2 **Risk assessment** is the identification and analysis of relevant risks to the achievement of the objectives (provided that there are identified operational, financial, and compliance objectives). Mechanisms are needed to identify and deal with the special risks associated with economic, industry, regulatory change.
3 Based on the analysis, the risks are managed through policies, procedures, techniques and mechanisms. **Control activities** include approvals, authorizations, verifications, reconciliations, performance reviews, separation of duties, password procedures, inventories, etc.
4 **Information and communication** processes are essential to business and internal control. The challenge is to get and give information on time, in a relevant, reliable and appropriate form all across the organization.
5 **Monitoring** and evaluation assesses the quality of the IC system's design, administration and performance over time. Revealed deficiencies should be reported to management.

COSO aims to provide standards against which business executives can assess their internal control systems and establish goals to improve. According to COSO, compliance is an objective of internal control activities. Since the initial COSO framework was created, the world has become more interested in the reliability of non-financial reporting, e.g. the above-mentioned internal control report according to SoX Section 404. Meanwhile, concerns about the adequacy of the framework have been voiced by many. [12]

Non-financial reporting (NFR) has received increased attention since the 1990s. Publishing structured non-financial performance information (e.g. on sustainability or on corporate social responsibility) delivers a well-controlled message.

Figure 1
Five components of Internal Control according to the COSO Internal Control – Integrated Framework

Reporting according to formalized frameworks allows stakeholders (including government regulators, potential employees, analysts, investors, media, competitors, etc.) to compare non-financial performance in time or in relation to other organizations. Reputation and pressure from stakeholders are the main driving forces in NFR [13]. In general, organizations are much more likely to manage risks of potential issues if they measure and analyze regularly. However, the reputational value might be considered more important than the added value of the environmental or social performance itself.

It is not only the COSO framework that reveals the strong link between risk management and compliance management. In April 2005, the Basel Committee, a global standard-setting organization, published a high-level paper for setting the requirements for a compliance function in banks. "The expression '*compliance risk*' is defined in this paper as the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organisation standards, and codes of conduct applicable to its banking activities (together, '*compliance laws, rules and standards*')." [14]

Finally, a distinction between risk management and compliance management shall be made. Risk management aims to minimize, monitor, and control the probability and/or impact of unfortunate events or to maximize the realization of opportunities. Operational risk is "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems, or from external events." [15] Operational risk includes legal risk, but excludes credit risk, market risk, reputational risk and strategic risks. Operational risks can have compliance implications. Compliance management defines compliance risks with laws and regulations in focus. There is a segment of risks that are operational and compliance risks too.

Governance, Risk Management, and Compliance, or GRC, is a new umbrella term with numerous definitions given. These three functions are strongly related and could be integrated in order to avoid overlaps and gaps. GRC is rather an overall management approach to corporate governance, control mechanisms, risk and compliance.

3 Strategies, Actions and Resources for Managing Compliance in Organizations

How do organizations manage their responsibilities? In theory, compliance and ethics are two different approaches [16]. Compliance is focused on the rules (laws and standards) and is a principal management activity in the US where you can find a rules-based regulatory structure with top-down instructions. Ethics are strongly connected with compliance, but go beyond avoiding illegal practice. Corporate culture, values, attitudes, beliefs and practices add up to organizational behavior. The programs to introduce ethical codes, also called integrity based programs, focus on the elements of exemplary conduct, accountability, and transparency in organizational behavior. As opposed to the rules-based approach, it is called the principle-based compliance strategy (also described as 'comply or explain'), which is more present in the EU regulatory environment, where rigid, centralized regulation would hardly be possible.

In reality, ethical mistakes can have legal sanctions (e.g. the case of Computer Associates detailed in Box 2) and firmly affect the image of the corporation. Ethical failures can lead to reputational loss and/or legal penalties. Reputation is a valuable asset, and also one main motivating factor for compliance. (Also, a motivation for compliance could be fear of negative publicity and customer dissatisfaction, individual and corporate responsibility, and cooperation with the regulator. Motivation for non-compliance could be the high cost of compliance, unavailable expertise to meet compliance requirements, lack of knowledge or understanding of the letter and/or the spirit of the law, ignorance, and the great complexity of the organization. [17]) Therefore, most compliance programs combine the two theoretical approaches. The practice of developing a written code of conduct is widely used. In general, codes state an ethical framework, include procedures to report any violations and prospective consequences. The importance of the code can be measured in the implementation, enforcement.

The commitment of leadership is a key factor in compliance since it is the management that sets the standards of behavior, partly by example and partly by the tone of oversight, expectation and compensation. The organization and the executives are expected to devote time, attention, budget, staff and other resources to meet all obligations and prevent possible misconduct. Generally, the overall compliance program is the ultimate responsibility of one single compliance officer.

Revealed non-compliance also requires a lot of effort, time and money to come over. CA Technologies, former CA, is a large IT management software and solutions company, founded in 1976, which serves customers in more than 140 countries. In 2004, Computer Associates (CA) was charged with improper accounting practices, misstatements of revenue, materially false and misleading public statements, obstruction of the government's investigations and more. CA entered into a deferred prosecution agreement (DPA) [18], which included the following corporate reforms:

(1) creation of a compliance committee of the board of directors,

(2) the committee's report had to be published on the company's website,

(3) establishing a comprehensive ethics and compliance training program for all CA employees and appointing a chief compliance officer to oversee it;

(4) new comprehensive records management policies and procedures, as well as testing programs to ensure compliance,

(5) implementation of an improved financial and ERP system to strengthen controls, eliminate errors and enhance the internal audit function.

In 2007, after significant changes in the above mentioned areas, the company fulfilled the terms of the DPA and all pending charges were dismissed. "We will continue to demand a high level of transparency, ethical behavior and integrity from our entire organization. In meeting the terms of the DPA, CA has made great strides in putting in place the business systems, processes and procedures that will ensure its ability to grow and generate value for shareholders, customers and employees." [19] said John Swainson, CA's president and chief executive officer.

Box 2

Case study of Computer Associates International Inc.

The scope of compliance operations should be tailored to the specific company. First, the organization needs to identify the external and internal compliance risks faced by the company. This requires the thorough understanding of the legal and business environment, the industry and relevant expertise in corporate strategy and internal processes. The compliance program should be designed to address the compliance risk profile. In general, relevant compliance risks could be: fraud, corruption, product safety, health and safety, environmental compliance, IT, intellectual property, antitrust compliance, employment practices, social responsibility, human rights and more [20]. Please note that organizations face the risk of setting up an extended compliance scope but end up with less valuable outputs.

Companies should accurately calculate the reward of compliance versus the risk of noncompliance. It is useful to define the limits of compliance and its relation to audit, internal control, legal department and risk management.

The identified compliance issues require response strategies in the form of developing policies and procedures to address compliance risks effectively (see Box 3). Infrastructure and resources (including material, human, IT, financial, technical) have to be provided and assigned to enforce the program. To illustrate the high-complexity of compliance management, consider that to manage for example product liability compliance, the following business functions could be related: engineering, procurement, manufacturing, quality control, sales and distribution, and more. To ensure product compliance the organization needs a certain level of control across the entire supply chain.

Following an internal audit, a Global 100 company discovered evidence of contractual non-compliance due to a lack of adherence to policies and a failure to record documents in their system. First, the full extent of the non-compliance problem needed to be revealed. In fact, the contract generation process had inadequate controls and many agreements had been drafted outside of approved standards. As steps to better compliance, the contract database was rebuilt and integrated into the company's master database system, and effective controls were created around contract administration [21].

Box 3
Example of a specific compliance issue

In terms of reporting compliance issues we should differentiate between external and internal reports. On one hand, the changing regulatory environment for companies requires flexibility and on-going change in statutory reporting (e.g. Basel II, SoX). On the other hand, suspected law violations should be reported internally and escalated to the chief legal officer, CEO or the board through appropriate communication channels (e.g. whistle-blowing programs, compliance hotline). Most compliance issues are reported internally first and reported to authorities in case it's inevitable. Therefore, an effective reporting system must be established. There is a need for responding mechanism (investigation, follow-up, etc.) from the leadership to employees.

Ultimately, organizational compliance is the responsibility of all employees. The importance of awareness, education and training cannot be overestimated, and any conduct due to lack of knowledge is potentially costly. By training, employees can develop the perception that compliance management is an unnecessary obstruction to day-to-day business operations. Publications and web-based interactive training are widely used methods.

Periodic reviews of risk assessment, compliance policies are the way to improve the compliance program. Measuring, monitoring, audits, and assessing effectiveness help the management to see clearly the strengths and weaknesses of the overall compliance function. Reviews can help the organization to capture future compliance risks.

Furthermore, compliance should not end at the development of an isolated compliance function. Well integrated, proactive and comprehensive compliance

means that compliance consideration can be found throughout the business processes, and compliance helps to achieve business objectives and adds business value. For example, in cooperation with the human resources department the compensation system should be developed to encourage excellence, transparency and responsibility. Performance evaluation can incorporate motivating factors for ethical behavior.

4 Research Hypothesis and Methods

Compliance is a relatively new organizational function. Many organizations have compliance programs because of the regulatory requirement to have one. Today, in Hungary companies faces the challenges to comply with international regulation; for instance some multinational corporations quarterly work for SoX compliance. Consequently, there are compliance professionals, officers, managers, suppliers. Still, we do not hear or read much about compliance, and we cannot talk about a common knowledge or understanding. It is considered a rather private thing.

As a matter of fact, only large companies have the resources to manage compliance through a formal program. Small and medium-sized companies rather have some limited compliance function integrated as a way to manage business activities, supported by external partners.

Therefore, our future research will focus on the compliance function in highly regulated industries with large companies, such as banking, energy, pharmaceuticals, etc. in Hungary. We propose the test of the following research hypothesis:

Table 1

Proposed research hypothesis and research methods

	Hypothesis	**Research method proposed**
1	Effective internal control systems add value and have a positive impact on the long-term profitability of companies.	Case study research
2	Improved compliance leads to higher stock premium.	Statistical analysis of listed pharmaceutical companies to investigate correlation of stock premium and compliance costs.
3	More compliant companies have access to capital at lower costs.	Statistical analyses, case study research
4	Better compliance improves business operational efficiency.	The efficiency of some limited business operations in banks can be compared with Data Envelopment Analysis. This method will allow for the anonymity of

		banks if surveys are run through the Hungarian Banking Association. DEA is a nonparametric method used to measure efficiency of business services operating with multiple inputs and multiple outputs.
5	The risk management and compliance management is part of corporate culture and cannot function without the commitment of the management.	Interviews to be run with key compliance officers in several industries.
6	Better compliance comes with fewer conflicts and lower stress levels for employees.	Sampling and multivariate analysis are proposed to explore the relationship among compliance, conflicts and stress.
7	The degree of risk and compliance integration is a measure of maturity.	Research model based on Capability Maturity Model
8	Fully integrated controls reduce audit costs, improve business efficiencies and achieve higher ROI on compliance expenditure.	Document analysis. Compliance costs to be compared: headcount, administrative, program expenses, etc.
9	Improved compliance will attract and retain higher-talented workforce.	Longitudinal studies

The aim of the research is to reveal the added value of the compliance function to business efficiency or business productivity. The challenge is to identify the mechanisms and elements how compliance activities can promote business performance. A more profound understanding could support business decision makers and help outline areas for improvement.

Conclusions

In 2000, Enron published its Code of Ethics. By December 2001, the company had fallen and caused the most complex bankruptcy scandal in US history (later surpassed). Enron is a classic example of the insufficiency of self-regulation. This and the following corporate scandals accompanied by public indignation were accelerators to major reforms in the regulatory environment.

Keeping up with laws and regulations is a constant challenge for today's organizations; therefore compliance to laws and regulations is a risk in itself. As a reaction, compliance as a new corporate function has emerged. Traditional compliance issues are associated with law and regulation, including industry standards and practices. In a broader view, compliance is connected with transparency, accountability, ethical behavior, organizational structure and risk management. Corporations will take a cautious position in defining the scope of compliance in order to avoid beginning with many things but finishing with just a few.

Laws, standards, and voluntary codes set the framework of acceptable and desired business behavior. Corporations can improve their compliance by the setup of a

compliance program (including design, implementation and evaluation). However, no box-ticking will result in substantive change. Ethics, organizational behavior, and corporate culture are critical in good quality compliance management. Any improvement of compliance achieved can be demonstrated to investors, competitors and other stakeholders. In fact, an underlying motivation for compliance management is to build reputation and public trust.

As compliance awareness grows, a new profession has emerged. In Hungary, we estimate that thousands of employees regularly work to ensure compliance of a wide-range of corporations. Compliance in practice is a complex issue that requires interdisciplinary research since it lies on the borderline of law, finance, risk management and operations management. The last five years' financial crises have provoked numerous new discussions and much research. Compliance-related research delivering shared experience and best practices could be useful and convertible to the business sector. Future research should map the business value of compliance in large, regulated companies in Hungary.

Acknowledgement

We would like to thank Dr. Irén Gyökér and Professor János Kövesi for their support and valuable comments to improve the quality of this paper and László Bóna for suggesting this research problem in the first place.

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