

Can compliance restart integrity? Toward a harmonized approach. The example of the audit committee

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The *compliance-based approach* and the *integrity approach* have been the mainstream responses to corporate scandals. This paper proposes that, despite each approach comprising necessary elements, neither offers a comprehensive solution. Compliance and integrity, far from being mutually exclusive, reinforce each other. Working together, in a correct relationship, they build a harmonized system that yields positive synergies and which also advocates prudence (*phronesis*). It enables the generation of a culture of compliance that tends to minimize the technical and ethical errors in decision making. In order to explore an applied *harmonized approach*, we analyze the audit committee, a specific and broadly accepted regulatory instrument. Formed by non-executive members, regulation requires these members to be dedicated, qualified, and independent as a guarantee of efficiency. We show how the compound of those elements produces positive effects in a context of solid governance. We conclude that it is the strong relationship between efficiency and prudence, in the creation of a culture of compliance, which enables the minimization of errors.

1 | INTRODUCTION

Corporate scandals have become one of the greatest ethical concerns of this century (Coffee, 2005). Enron, Parmalat, WorldCom, or Madoff Securities are part of a long and nefarious list of reputable corporations that allowed or brought about irregular, unethical, and/or illegal behaviors. These debacles lead to serious economic costs and they have had devastating effects on the trust of investors and society. Krugman (2002) even asserts that in the years ahead Enron, not September 11, will come to be seen as the greater turning point in US society.

Regulators, academics, and society itself continue to debate about the causes of and remedies for these debacles (Bies, 2014). Do scandals arise because of the existence of bad apples—that is, isolated greedy managers—or bad barrels—that is, defective governance and control structures? (Ghafran & O'Sullivan, 2013; Treviño & Youngblood, 1990). To what extent could these debacles be attributed to ethical irregularities (bounded willpower) or the bounded rationality of managers and inexpert non-executive directors in a very complex world? How many can be ascribed to the lack of ethics on the part of the organizational culture or the executive members? The answers to these debates are dominated by two primary positions that coexist today and that, following Paine (1994), we designate as the *compliance-based approach* and the *integrity approach*.

The *compliance-based approach* attributes the high-profile failures to inappropriate corporate governance combined with lax control

systems. Weak governance structures broke the roots of companies' self-regulation and generated perverse incentives that enabled dishonest or undiligent managers to take advantage of the circumstances causing several technical—failures in the perception of the complexities of financial or operational problems—and/or ethical irregularities, which led to debacles (Csaszar, 2013). As Paine (1994, p. 106) explains, "Managers who fail to institute systems that facilitate ethical conduct share responsibility with those who conceive, execute, and knowingly benefit from corporate misdeeds". Because, when bad apples can damage the barrel through institutionalization and moral disengagement (Shu & Gino, 2012; Shu, Gino, & Bazerman, 2011), the barrel itself must be repaired.

To ensure that the company operates with honesty, this approach recommends stronger self-regulatory mechanisms of governance, supervised by regulators, and a more incisive spirit of "command-and-control" based on internal auditors, evaluation of risks, and compliance (Thibodeau & Freier, 2014). In response to the recurrent implication of executive directors in the scandals, and with the belief that they play a crucial role in mitigating agency costs and conflicts between controllers and minorities, the presence of independent non-executive members (NEMs) on boards is emphasized in the repair of the barrel (Rashid, 2015).

Since Enron, the level of adhesion to the *compliance-based approach* has increased dramatically. Regulatory proposals such as the Sarbanes-Oxley Act (SOX) (2002)—one of the major regulatory

responses to restore the integrity and confidence in the markets through more efficient and tighter control (Zhao & Ziebart, 2015)—have grown exponentially in the United States as well as in Europe (Collier & Zaman, 2005).

Sapira (1999) suggests that regulations are often introduced as a public reaction to examples of behavior that are considered unacceptable. Despite the fact that integrity cannot be guaranteed by law, some authors certify the positive impact of SOX on transparency, governance, accountability, and investors' trust (Asare, Cunningham, & Wright, 2007), on the reduction of risk-taking behavior and on fraud reduction (Barger, Lehn, & Zutter, 2010). Fernandez-Rodriguez, Gomez-Anson, and Cuervo-Garcia (2004) confirm the positive reaction to announcements of compliance, especially in listed companies.

A different path, the *integrity approach*, considers that strengthening regulation, the independence of the board, having stricter standards, compliance, and control systems is not sufficient (cf. Carson, 2003). The 2008 financial meltdown revealed that changes have not solved the problem. Some authors (Greer & Tonge, 2006; Page & Spira, 2005) emphasize that new rules and standards could produce a cosmetic effect. They could preserve the appearance of response to concern, repelling criticism, without producing changes and even conserving the level of ambiguity.

On the other hand, other authors (Bradley & Ziniel, 2017; Han, Kang, Salter, & Yoo, 2010; Kwok & Tadesse, 2006; Nurunnabi, 2015) provide evidence that both the legal systems that provide consistent and comprehensive "rules of the game", and national and corporate culture, jointly determine managers' discretionary accounting choices. In this sense, in spite of the convergence, a uniform reporting standard might not necessarily translate into uniform reporting practices. Leung, Bhagat, Buchan, Erez, and Gibson (2005) warn about the simplistic view of culture, according to which there has been a tendency to examine the static influence of a few cultural elements in isolation, neglecting contextual and ethical variables. Rasche (2010) also declares that, even though standards are an indispensable and practical option to work towards increased corporate responsibility, there is still plenty to think about when it comes to critically reflecting the application of standards in practice (nationally and particularly). Thus, culture and ethics must be contemplated. Along these lines, Grant and McGhee (2014) underline that traditionally, corporate governance reform has taken a structural approach, neglecting the personal dimension.

Preventing fraud has more to do with the improvement of ethical environments and therefore the battle should focus on changing the incentives of the agents—both executive and NEMs—and their commitment. Greer and Tonge (2006) argue that corporations must operate an ethical code based upon values such as fairness or integrity. In the case of NEMs, authors emphasize that, despite expertise and technical independence being a necessary condition, the sufficient condition arises when we ensure their honesty and commitment (Brouard, Bujaki, Durocher, & Neilson, 2016; Wyatt, 2004).

In "Has compliance killed ethics?" (2006), Martens and Barry state that compliance may not have killed ethics. Weber and Wasieleski (2013, p. 614) answer that, clearly, compliance has a prominent place in the minds of ethics and compliance officers as a key motivator. They

call for a rethinking of methods to improve the efficiency of ethical programmes in organizations. This paper attempts to contribute to this debate and more broadly to that of the causes and remedies for corporate scandals by proposing a new approach that goes beyond the traditional views of the *compliance-based approach* and the *integrity approach*. Specifically, we try to answer the following research question: How can compliance and integrity influence and enhance the development of an appropriate culture within an organization? We argue that, in spite of proposing necessary elements, the described approaches turn out to offer only partial solutions. We agree with Wagner and Dittmar (2006, p. 134), who support that good governance is a mixture of the enforceable and the intangible, a mix of discipline, structure, and ethical values at board and executive levels that the rest of the organization would want to emulate (Treviño, den Nieuwenboer, Kreiner, & Bishop, 2014). In fact, far from being mutually exclusive, compliance and integrity reinforce each other. Working together, in a correct relationship, they build a harmonized system and create the conditions that allow the whole system to operate (Greer & Tonge, 2006). However, what is this "correct relationship"?

Following Nicomachus of Gerasa (1926), we understand harmony as being "The union of things formed by various mixed substances and the reconciliation of the diverse a consensus of it what dissents." In this sense, we suggest that the harmonization of compliance and integrity reaps positive synergies and it introduces prudence (phrónesis). This is the cornerstone of our *harmonized approach*: prudence as practical wisdom enables the generation of a culture of compliance that tends to minimize the errors in decision making—in a permanent reevaluation—and guides to efficient and legitimate leadership. Thus, in a prudential and balanced view of corporate culture (Kaptein, 2017), the exercise of integrity demands the harmonization of moral and technical engagements (Meyer, 2015; Moore, 2015), integrating competences and personal virtues (Morales-Sánchez & Cabello-Medina, 2015; Spraggon & Bodolica, 2015) into the specific organizational character (Rua, Lawter, & Andreassi, 2017).

Using a therapeutic simile, compliance could be understood as a palliative treatment; it does not address the problem since it does not avoid the recurrence of the disease (Greer & Tonge, 2006), but it tries to attenuate or cover up the symptoms. In the same line, the *integrity approach* seeks to tackle the root problem by addressing the actor directly, that is, the moral person, in some sort of preventive gene therapy. This gene therapy, which could be effective in certain aspects, does avoid the biases and errors characteristic of the human condition. In our opinion, the preventive and the palliative approaches are both necessary, but used separately they fall short. By contrast, the *harmonized approach* could be understood as some sort of vaccine that allows us to improve our defense mechanisms—compliance—and at the same time strengthen and promote our healthy habits, physical—command and control—and moral, both individual—integrity—and collective moral engagement (Shu & Gino, 2012; Shu et al., 2011), fashioning a prudential governance.

In order to explore the insights of an applied *harmonized approach*, we conduct a conceptual analysis and we explore a specific and largely extended regulatory instrument: the audit committee (AC). The AC

deals with the detection and fight against conflicts of interest (Klein, 2002), the certification of the goodness of corporate information, and the control of opportunistic behavior of employees and managers (Armstrong, Barth, Jagolinzer, & Riedl, 2010).

Choosing a specific committee, and not the board as a whole, is a convenient option because nowadays a large proportion of board activity takes place in committees (Adams, Ragunathan, & Tumarkin, 2015). Choosing the AC is also suitable for the purpose of this paper for several reasons. The AC is an important governance mechanism whose malfunctioning causes strong side effects as shown by financial scandals. Its structure and requirements are thoroughly regulated in comparison to other committees (Bolton, 2014). These requirements relate to the characteristics of the members: expertise, independence, and diligence. Hence, the AC is an unbeatable scenario to show how, adding prudence to those compliance requirements, it is possible to make the AC more efficient and trustworthy.

After a description of the technical and ethical errors that have been present in inadequate decisions behind corporate scandals, this paper continues with the presentation of the compliance and the integrity approaches in Section 2. Section 3 describes our *harmonized approach*. Section 4 explores the AC, placing particular emphasis on qualification, independence, and dedication as isolated elements that have the potential to create positive synergies and corporate culture. Section 5 presents the conclusions.

2 | COMPLIANCE VS INTEGRITY: TWO CONNECTED APPROACHES

At the core of all of the scandals of the early 21st century, there was a chain of inadequate decisions that undermined corporate self-regulation.

Two elements concur in the emergence of an inadequate decision: (a) a cause of voluntary nature that determines the understanding to form an erroneous judgment and (b) an objective error basis, that is, a reason that explains what has been judged. In brief, it is the combination of an objective basis and the influence of human will in that error (Del Barco, 1994). The counteraction would require simultaneously controlling both elements. On the one hand, companies need to endow themselves with an objective basis, a regulatory body, and institutions that, added to its customs and "language," create their culture. Culture is the framework that sustains their theoretical "truth," which is the basis of self-regulation. On the other hand, it is necessary to align the will of the individual agents with that culture. Misalignments might be due to lack of will (bounded willpower) or to lack of rationality (bounded rationality). Therefore, even though it is not possible to isolate completely the different types of errors, as they are usually intermingled in practice, in theory we could categorize inadequate decisions according to their nature. Hence, these may be technical or ethical, or a combination of both (Figure 1).

Regarding the presence of technical errors in decision making, March and Simon (1958) and March and Savon (1984) explain that humans do not respond to the neoclassical archetype; on the contrary, individuals have cognitive and behavioral boundaries of rationality. Regarding cognitive facets, agents present both limited knowledge and

limited computational capacity, and possess information only problematically associated with the decisions at hand. In fact, agents must cope with loosely relevant information, inherently ill-structured problems, or purposes in conflict. In consequence, their decisions do not always turn out to be correct.

There are also social-behavioral components of bounded rationality. Levitt and March (1988) argue that managers' preferences are never perfectly revealed and change over time as the decision maker gains experience. Prentice (2007) explores the tendency toward optimism (over-optimism) that can lead to irrational beliefs and injurious decisions, over-confidence, self-serving bias, or a tendency to agree with the majoritarian option. Beecher-Monas (2003, p. 373), in the setting of the case of Enron, explains that people in a situation of relative loss appear to frame the risk differently from those in a situation of relative gain, exhibiting a great willingness to take an uncertain gamble.

However, even if bounded rationality is diminished at the margin, agents—and the crises caused by the agents—are also characterized by bounded willpower in at least two variants: bounded self-control and deliberated unethical behavior. The weakness of will, described by Aristotle through the term *akrasia* (Peijnenburg, 2000), refers to a certain incontinence or bounded self-control that moves the agent to act against his best prudential interest. The individual, who has a stronger preference for present rewards versus future ones, is unable to accurately evaluate the consequences, thus generating a gap between optimum decision and action (Rizzo, 2016). Furthermore, despite being aware of both the corporate code or the law and his self-interest, the agent can deliberately decide to violate the rules in a clear unethical action. As in the case of technical errors, bounded willpower produces misalignments with devastating consequences for corporations and society. Therefore, the debate focuses on how to counteract both types of inadequate decisions efficiently.

The *compliance-based approach* pays special attention to the presence of the above-described technical errors in most recent scandals, proposing its minimization. Bazerman, Loewenstein, and Moore (2002) suggest that even when accountants try to be objective and impartial, biases affect their judgment. The corporate auditing area seems to be a particularly fertile ground for these biases due to the ambiguity and the scope of their decisions, for example, concerning revenue recognition, previous attachments, such as from Andersen to Enron, familiarity, and so on. Despite admitting that it is impossible to guarantee perfect organizations with fallible and imperfect people (Christensen & Knudsen, 2010), it acknowledges that some decision-making structures cause fewer errors than others (Csaszar, 2013). Given that in governance technical errors derive primarily from failures in the perception of the complexities of the financial or operational problems of the company, this approach suggests reducing complexity through the standardization of processes, basis of decisions, and the selection of expert outsider members for the board. For instance, the use of the International Financial Report Standard (IFRS) on financial statements helps participants in the world's capital markets to make economic decisions. Pacter (2015) shows that in 2015, 83% of jurisdictions already required the use of IFRS by all or most of their public companies. The reform of the International Auditing and Assurance Standard Board follows in a

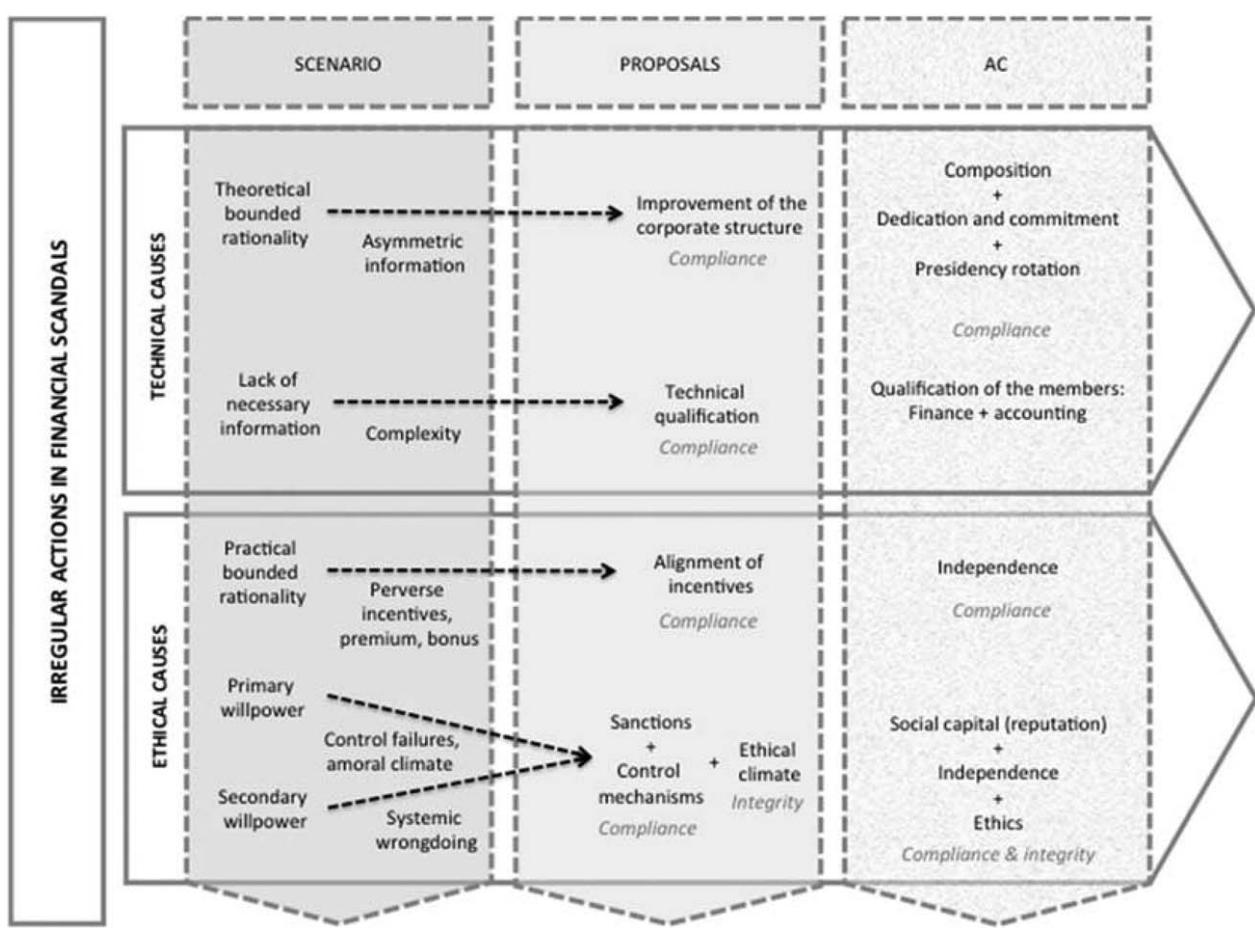


FIGURE 1 Potential irregular actions in financial scandals

similar vein. In spite of several non-public initiatives as cited, most changes came from legislative sources such as SOX (2002) that attempted to impose ethical behavior and control via law (Rockness & Rockness, 2005; Zhao & Ziebart, 2015). With respect to bounded willpower, this approach suggests a strategy of command-and-control invoked to minimize the profitability of unethical behavior in a cost-profit analysis. In the end, it proposes an ethical programme from a legal point of view, focused on the transaction cost of inadequate decisions (Stucke, 2014).

While the end of the 20th century contemplated a great upswing of ethical programmes in corporations (Weber & Wasieleski, 2013), the 21st was born with the extension of compliance around SOX. This evolution was not novel; more often than not, regulatory changes followed corporate scandals. The novelty of SOX, which could be traced in subsequent regulations such as in the Dodd-Frank Act (2010), is the way it understands the role of regulation on corporate activity. Before SOX, the only source of regulation came from self-regulation, and regulators stayed outside of both the development of standards and their supervision. Ethical codes are a good example of this approach. However, because scandals came from self-regulated companies, critical voices forced the rethinking of the role of the government in corporate governance. As Coglianese, Healey, Keating, and Michael (2004) explain, the central debate post-Enron was how to

restore corporate integrity and market confidence without overreacting and stifling the dynamism that underlies the economy.

The financial crisis of 2008 opened a new chapter on regulatory responses. For instance, the Dodd-Frank Act (2010) incorporated the most significant changes in financial regulation in the United States since 1929 (Ghafran & O'Sullivan, 2013). The new approach discourages a purely deterrent regulatory approach and supports a mixed system by which regulators exercise an appropriate legal force, which conditions the norm, and establishes a set of guidelines to ensure effective implementation of the system of self-regulation and self-responsibility. The literature certifies that formal self-regulation results in improved compliance practices and outcomes (Short & Toffel, 2010). Therefore, the discussion focuses on the selection of instruments or regulatory mechanisms that enable the real implementation of the commitments made by the self-regulated organization. It is in this context that the empowerment of the AC emerged.

Although compliance has been the mainstream approach, it has also attracted detractors. The *integrity approach* judges the combination of regulatory and control responses to be incomplete. Nevertheless, perfect control is impossible and, if it were possible, it would be so expensive as to be inefficient. Anand, Ashforth, and Joshi (2004) estimate that one-third of all frauds in private companies was not detected by control systems, but rather accidentally. ACFE (2006) suggests that

wrongdoing is much more likely to be detected by a tip-off, with 60% of these coming from employees. Therefore, we must suppose that some level of unethical behavior will always persist. Law or compliance cannot ensure obedience. A moral strategy is needed that changes the attitude to regulation (Reynolds & Bowie, 2004).

Supporters of the *integrity approach* emphasize the bounded willpower and the necessity to include ethics in the design of any strategy of accountability and long-term survival. For instance, Dellaportas et al. (2005) believe that failures in ethical conduct rather than technical errors seem to have caused many of the large corporate collapses and scandals of recent times. Lail, MacGregor, Marcum, and Stuebs (2017) add that fraudulent behavior has a deep root related to professional identity. Hence, the battle should focus on aligning the individuals with the values of the organization and on emphasizing the "awareness of the importance of professional ethical behavior" (Wyatt, 2004, p. 46).

3 | THE HARMONIZED APPROACH: THE CHALLENGE OF INTEGRITY IN LEGAL COMPLIANCE

From a critical viewpoint, we should note that both the *compliance-based approach* and the *integrity approach* offer valid arguments. Nowadays, it is crucial to have a well-articulated strategy of legal compliance and control and strong governance to reduce technical errors. However, it is true that, assuming bounded willpower of the individual, there is an inevitable gap between regulation and successful implementation as there is between law and ethics (Page & Spira, 2005; Weaver, 2014). Without norms, structures, and standards, ethics would be reduced to voluntary regulation and it still may be the case that an ethical organization incurs serious technical errors—for example, due to the lack of strategic thinking—causing debacles (Puranam, Stieglitz, Osman, & Pillutla, 2015); but without ethics, it would be impossible to embody a culture of compliance (Parker & Gilad, 2011).

There are several reasons to harmonize the two approaches in order to minimize inadequate decisions:

1. Since both bounded willpower and bounded rationality are present in the human condition, technical and ethical responses must be harmonized.
2. In practice, technical and ethical problems occur simultaneously and reinforce each other.
3. Professionalism, i.e. the consistent effort to seek the truth in order to make adequate decisions, is a technical condition as well as an essential part of an ethical character.
4. The ethical brain is not a permanent condition: constructing an ethical organization is a perpetual process.
5. If strong bad incentives exist, weak will may be fostered in previously ethical members. Thus, although not being sufficient conditions by themselves, control and standardization are needed.

However, the control of human actions in corporations cannot be reduced to a normative consideration given that the simple

establishment of codes of conduct does not guarantee the achievement of the intended goal (Kaptein, 2015). Hence, the objective of the *harmonized approach* is neither the mere compliance with the laws and rules nor the juxtaposition of ex-ante ethical members, but the creation of an authentic culture with an ethical basis in which a clearly understood level of professionalism is an important element (Arnold, Bernardi, Neidermeyer, & Schmee, 2005). Beyond ensuring that individuals attempt to work with the greatest responsibility and "within the law," it provides a clear set of reasons in favor of human action that is the result of a strong awareness of what it means to do things "right," beyond the interests of efficiency or productivity.

Even though having a compliance approach is efficient because it helps to define the boundaries of the behavior of the individual—and to limit the undesirable consequences of his bounded rationality and bounded willpower—and, therefore strengthens the barrel, the most important elements are the values that sustain these norms. These values guarantee regulatory compliance (Oded, 2013; Page & Spira, 2005).

In this context, the *harmonized approach* tackles the root of a fundamental question concerning human behavior, that being "why do we comply with the law?" For the human being the endowment of laws and norms is not a mere technical issue, not even intellectual, but an existential condition: a means to an end. Legal and moral rules are just the means, and the aim is to find a way to improve and develop the entire range of activities that are characteristic of the human being. The final goal is to make of the human life a good life, a life in community that it is never without problems or conflicts. The issue is: why would somebody follow the rules, when if he cheats he could make a profit and by complying he would incur negative benefits or a cost?

The answers are many and each of them generates a wide range of consequences that opens up a multiplicity of possibilities. Yet, it is worth highlighting the following reasons. An individual might follow the rules because he lives in a panoptic; he seems like a prisoner to the observer. Following the ideas of Benham (1907), we comply with the law because doing so provides some "pleasure" or at least it avoids a "pain." If this utilitarian hedonism is set as a moral criterion, it leads to an instrumentalization of human action where seeking good is reduced to seeking pleasure. In other circumstances the punitive nature of violating the law might be a sufficient deterrent and ensure compliance. However, complying with the law simply not to be punished leads to another reductionism: one that believes that the human condition is just a system of attractions and repulsions. Last, but not least, we might act according to the rules because we seek integrity. Integrity is a core value of our ethics as well as an aspiration, that is, it is not given to the human being.

Values provide the reason for complying with a particular rule and also they generate an awareness of their importance in the individual, because they harmonize with his moral nature and with the strategic objectives of the company. When a corporation clearly sets the objectives that it pursues, and these are articulated in a code of behavior that lead employees to achieve them correctly, then, the rules can be considered not as something alien to the individual but as a positive means that can lead to a good end. This connection between means

and ends—both aligned to the moral nature of man—leads to the repetition of acts, which become habits of behavior. In turn, these habits generate in the individual a number of virtues, which consolidate and end up generating a “culture” of how to think, decide, choose, and act morally. Yet, there must be a connection between the “business action-decision” and the “moral action-decision”; the cornerstone of these actions-decisions is *prudence*.

In the ancient world, a prudent and wise person is not one that has a technical knowledge about something, not even a detailed knowledge about a particular subject. A prudent person is one who is able to live a good life. In this sense, wisdom is more than mere knowledge about the world or about companies; it is, above all, a *savoir-vivre*. Having a “true” theory about reality is a pre-condition, but the real identity of a “wise man” is his ability to apply to his existence all that he knows to make his life good (and happy). That vital ideal rests on three fundamental pillars: autonomy, “*filiation*” (i.e., *philía, φιλία*), and inner freedom. In our time, and in the context of the discussion of this paper, these could be translated by terms like independence, trust, and integrity.

In our approach, *prudence* is not an abstraction but it has to be bounded to the action. *Prudence* is the hallmark of a deliberate action that wants to be effective while being fair, which aims to be operative while being eminently moral, which is certainly useful, but whose goal is not pure self-interest but what is convenient. *Prudence* should be applied to every human matter, although it is not exclusive to any of them. *Prudence* leads to a judicious behavior, not motivated by whim. It is a practical wisdom that, relying on reflexive knowledge, allows exemplariness to develop (Guevara, 2009). Therefore, *prudence* should always be present in the functions of governance. Some integral parts of *prudence* are: memory in the sense of experience, intellect in the sense of intellection of the singular (i.e., clear evaluation of the situation), docility to follow good advice, promptness in execution and reason in the sense of what it is to be wise or fair. To this, it should be added, the “*forecast*” and “*provision*”, the consideration of all the circumstances, and caution.

Hence, the harmonization of an approach of compliance with an approach of integrity into a culture of compliance provides a prudential environment, not merely a normative framework.

4 | THE AC AS AN EXAMPLE OF A HARMONIZED APPROACH

An AC could be defined as a committee of the board of directors with responsibility for overseeing auditing activities, primarily assigned to ensure the integrity and credibility of the corporation’s financial statements, the independence of external auditors, and the adequacy of internal control systems (Collier & Zaman, 2005). Often, it encompasses other responsibilities such as the review and assessment of the internal auditing function, the setting of auditor fees, the whistleblowing policy or the review of regulatory compliance, and risk management activities. In contrast to other governance reforms enacted by SOX, and as the ultimate monitor of the financial reporting process, the AC appears without controversy in most best practice recommendations (Cuervo-

Cazurra & Aguilera, 2004; Krishnan & Visvanathan, 2008). In fact, due to regulatory pressures in the post-Enron era and the globalization of market forces, its diffusion has increased in many countries with Anglo-Saxon and continental traditions (Collier & Zaman, 2005; European Commission, 2003, p. 15).

SOX Section 301 reaffirms the pertinence of the AC but redesigns its function and requirements. Bolton (2014) underlines that the focus on AC is greater than that on board or other committees, as the characteristics of AC members are subject to greater scrutiny. If, before 2002, qualification and independence were the essential capabilities with which to guarantee effectiveness, dedication is added as a necessary condition.

In order to demonstrate the insights of the *harmonized approach*, we shall study the AC. This committee shows the partial character of the solutions to inadequate decisions in corporations. Furthermore, the AC’s regulatory requirements—qualification, independence, and dedication—allow us to explore how it could be turned into an efficient instrument if *prudence* were added.

4.1 | The qualification of the AC members

One of the principal pre- and post-SOX differences in the regulatory requirement of the AC is the exigency of the “expertise” of the members, especially for listed companies, which is consistent with the intention to avoid technical errors present in scandals (DeFond & Francis, 2005; DeZoort, Hermanson, Archambeault, & Reed, 2002; DeZoort, Hermanson, & Houston, 2008). Section 407 of SOX mandates the Securities Exchange Commission (SEC) to adopt rules to require the AC to be “comprised of at least one member who is a financial expert” proposing a narrow definition of “financial expert,” essentially identified with accounting expertise. However, after soliciting comments from corporations and professional associations, the SEC adopted a broader definition including certain types of non-accounting financial expertise looking for “the ability to ask the right questions to determine whether the company’s financial statements are complete and accurate” (Release Nos. 33-8177; 34-47235; File No. S7-40-02, January 24, 2003). This inclusion started a controversy in both academic and professional forums.

4.2 | The independence of the AC members

Independence, perhaps the most recommended practice on corporate governance, has been at the center of corporate reforms (Davis, 2004). There are two alternative ways to consider a person as being independent (ID). Regulations define ID by way of status, that is, with reference to the absence of specific relationships with the company or its controlling shareholder. In terms of SOX, Section 301, an ID is the person who does not receive, other than for service on the board, any consulting, advisory, or compensatory fee from the issuer and is not an affiliated person to the issuer, or any subsidiary thereof. Thus, ID is defined as an outsider, calibrating this term as having a lack of financial ties with the organization or familial ties to its managers. An ID is, in fact, a non-executive and non-interested member whose only compensation

for sitting on a board comes from director's fees and who has no potentially conflicting business interests, past or present, with the company (Karmel, 2013).

Some authors have revealed a misperception of this view, describing ID in a more contextual way in accordance with the Delaware Court's interpretation. This conception differentiates between ex-ante independence and high-performed independence, which includes the critical components of good decision making: time, information, and knowledge (Sharpe, 2011). It always focuses on ex-post conflict situations (Rodrigues, 2007). Fairfax (2012, p. 171) shows the necessity to distinguish between interested and disinterested directors, who will not benefit financially from the transaction unless shareholders more generally enjoy the benefit. Disinterest is a necessary but not sufficient condition for independence. In the context of a specific decision, an independent director has no ties with any particular interested individual and is not otherwise controlled by that individual in a manner that compromises his decision-making process.

4.3 | Dedication of the AC members

Despite the fact that regulation does not provide specific details, a key attribute of a diligent AC member is to dedicate sufficient time to his responsibility. The commitment is impossible if he does not devote enough time to the company, even though there is no further determination of how much is "enough".

4.4 | The harmonized approach

In this paper, we have argued that both compliance and integrity approaches, despite including necessary elements that reinforce each other, offer partial solutions to bounded rationality and bounded will-power. We consider that palliative and preventive solutions are unable to solely prevent future crisis. In this sense, we have proposed to build a harmonized system with prudence (*phronesis*) as its cornerstone. Prudence as practical wisdom enables the generation of a vaccine that is a culture of compliance that tends to minimize the errors in decision making, in a permanent reevaluation, and leads to an efficient and legitimate leadership.

In order to assess the *harmonized approach*, we have studied the AC's regulatory requirements (i.e., qualification, independence, and dedication) in order to examine whether the focuses on compliance and on integrity in isolation would permit, by themselves, the minimization of irregular decisions—such as earnings management—leading to optimal long-term decisions and higher quality disclosures. Our response must be negative: a critical view of the AC's regulatory requirements shows, on the one hand, the positive and required effects of both compliance and integrity and, on the other, their partiality.

We consider that compliance could be an efficient "palliative treatment"; it does not guarantee the eradication of the disease (i.e., earnings management) but it relieves the symptoms. We believe that reinforcing the regulation to minimize technical errors becomes absolutely indispensable but we understand that there must be a strategy of greater depth through the development of an organizational culture.

Understood as culture, compliance exceeds the effects of its component elements, with ethics being the nexus among these.

However, both academics and practitioners show the partiality of the regulatory requirements of the AC. On the one hand, as has been evidenced by the literature, these elements do not work alone as technical competences but in a context of strong governance. For instance, with respect to qualification, several studies underline that isolating essential technical factors in complex inadequate decisions is impossible. In this sense, the expertise called upon to obtain trusted financial reporting is affected by other characteristics of the board of directors such as the governance context (DeFond & Francis, 2005; DeZoort et al., 2002; Verriest, Gaeremynck, & Thornton, 2013). Badolato, Donelson, and Ege (2014) find that financial expertise does not deter irregularities unless the AC also has high status. Krishnan and Visvanathan (2008) show that, in weak boards, the presence of accounting financial expertise on the AC is ineffective with regard to promoting conservative accounting. DeZoort et al. (2002) emphasize the importance of evaluating how the effectiveness of AC financial experts is affected by attributes such as independence, share ownership, multiple directorships, and tenure. Dhaliwal, Naiker, and Navissi (2010) also underline that quality is associated with accounting experts that are independent, hold fewer multiple directorships, and have lower tenure in their firms. In a study focused on determining the personal and professional considerations that influence a confidentiality decision of auditors, Arnold et al. (2005) argue that thinking of the greater good for all stakeholders, a movement from a strict "rules-oriented" mode of reasoning to a more "principles-oriented" level of reasoning, is needed in consonance with Adams, Malone, and James (1995). In relation to dedication, Ferris, Jagannathan, and Pritchard (2003) argue that multiple directorships of AC members may reflect their reputation as good monitors and also increases experience and effectiveness. Again, the complex relationship between elements must be detached. Ebrahim (2007) suggests that earnings management is negatively related to AC independence and that this relation is stronger when the AC is more active. However, this result is not valid for board activity. Sultana (2015) finds that accounting conservatism is significantly higher among firms with ACs that meet frequently. Abbott, Park, and Parker (2000) find that with active ACs, there is a decreased likelihood of both fraud and non-fraudulent misstatement.

On the other hand, technical competences work together with human capabilities through the development of an organizational culture. If compliance is understood as a culture, the outcome goes beyond the individual effects of its component elements, and ethics becomes the nexus that bonds them together.

The example of expertise is illustrative. As has been pointed out, expertise is vital to reduce technically inadequate decisions with professionalism being a component of an ethical character. However, expertise and knowledge must not be confused. Knowledge is superior in, at least, one element: it takes a position around truth. The tendency towards the truth presupposes expertise but it cannot be attained in books or by a CFA certificate because it does not arise from practical or theoretical understanding. It comes from the interaction between information, expertise and ethics, which produces prudent decisions. Practical wisdom is essential to judge very complex actions and also

simple actions in a long-term context. Regulation does not lead to the truth. Fraud stinks. Those who have smelled the aroma of nards many times know how to recognize it. However, sometimes these flowers camouflage their smell. And it is only the proposed harmony, as a proxy for seeking the truth, which is able to perceive those fine scents.

Another good example is dedication. The literature describes positive effects using frequency of meetings as proxy for the diligence of the AC. Krishnan and Visvanathan (2008) show a positive association between diligence and higher audit quality and the detection of internal control weaknesses. Xie, Davidson, and DaDalt (2003) find that AC diligence and earnings management are negatively related, while others do not find any evidence (Baxter & Cotter, 2009; Bédard, Chtourou, & Courteau, 2004). The term "diligence" derives from the Latin noun "diligere," which has a double meaning. First, the fact of being united to something or to someone, to bond: *legare*. Second, it also means to love. Because one can be bound to someone by their own will with freedom or through being forced. Hence, diligence should be understood as an enthusiastic engagement. This engagement will be ethical in the sense of Shu et al. (2011) and Shu and Gino (2012) when the enthusiasm comes from doing what is right in the moral sense. That is, not what is correct in the sense of professional ethics but in the sense of the independence of the individual based on ethical principles, the personal ethics that take intention, action, and the circumstances into account (Arnold et al., 2005; Bazerman et al., 2002).

The view of regulation as palliative treatment is evident in AC. It does not cure the patient but tries to attenuate or cover up the symptoms without solving the problem. It helps the patient to feel better without necessarily becoming well. Thus with the apparent improvement that the patient experiences, which is a positive consequence of palliative care, there is a negative outcome, which is a distortion of the authentic levels of moral exigency, as reality is not affected but just the perception, losing sight of reality itself.

There is no objective assessment to detect the integrity of people. Therefore, we tend to look for approximations—for example, certificate of penalties, adherence to some kind of creed, family situation, tasks, or positions held, so on—and select people of a certain profile, in such a way that those secondary features depict an adequate image of what is meant by integrity. In this way, these approximations become a preventive therapy.

By contrast, the *harmonized approach* could be understood as some sort of vaccine. With the human condition, we have inoculated bounded rationality and limited willpower and, on that basis, we build our own identity, which makes us aware of both our possibilities and our limitations. For these reasons, we constantly strive to improve our immune system, our compliance mechanisms, and at the same time strengthen and promote our healthy habits, both individual (integrity) and collective (moral engagement) (Shu & Gino, 2012; Shu et al., 2011).

5 | CONCLUSIONS

The *compliance-based approach* and the *integrity approach* have been the mainstream and competing responses to corporate scandals. The

first approach attributes failures to inappropriate corporate governance combined with lax control systems. Weak governance structures broke the roots of companies' self-regulation and generated perverse incentives that enabled dishonest or undiligent managers to take advantage of the circumstances behind several technical and/or ethical irregularities, which led to debacles (Csaszar, 2013). This approach particularly focuses on the presence of the technical errors in the most recent scandals, deriving from technical and social-behavioral components of bounded rationality. Given that in governance technical errors derive primarily from failures in the perception of the complexities of the financial or operational problems of the company, this approach suggests the reduction of complexity through the standardization of processes and the selection of expert outsider members to the board. The approach also pays attention to bounded willpower, suggesting a strategy of command-and-control instigated to minimize the profitability of unethical behavior in a cost-profit analysis. In the end, it proposes an ethical programme from a legal point of view, focusing on the transaction cost of inadequate decisions (Stucke, 2014). To ensure that the company operates with honesty, this approach recommends, first, stronger self-regulatory mechanisms of governance, supervised by regulators and, second, a more incisive spirit of "command-and-control" based on internal auditors, evaluation of risks, and compliance (Thibodeau & Freier, 2014).

The *integrity approach* considers that paying attention to compliance and control systems is not sufficient. The 2008 financial meltdown revealed that changes have not solved the problem and that no regulation, which has traditionally neglected the personal and cultural dimension, is able to prevent another failure. Preventing fraud has more to do with the improvement of ethical environments and therefore the battle should focus on changing the incentives of the agents and their commitment. Despite compliance being the necessary condition, the sufficient condition arises when we assure their honesty and commitment (Brouard et al., 2016; Wyatt, 2004).

This conceptual paper has attempted to contribute to this debate, and more broadly to that of the causes and remedies for corporate scandals, by proposing a *harmonized approach* that goes beyond the traditional views of the *compliance-based approach* and the *integrity approach*. We have argued that, in spite of the fact that both approaches propose necessary elements, neither on their own offer more than partial solutions. Compliance and integrity reinforce each other by creating positive synergies that lead to a culture of compliance. Even though it is impossible to guarantee the absence of new corporate scandals, the culture of compliance enables the simultaneous minimization of inadequate decisions due to the bounded rationality and the bounded willpower of individuals. The culture of compliance leads to a scenario in which prudence takes on a central role as a cornerstone in the decision making.

We have set out several reasons in favor of harmonizing the two approaches in order to minimize inadequate decisions. First, because bounded willpower and bounded rationality are both present in the human condition, technical and ethical responses should therefore be harmonized. Second, because in practice, technical and ethical problems concur simultaneously and reinforce each other. Third,

professionalism is a technical condition as well as an essential part of ethical character. Fourth, because constructing an ethical organization is a continuous process, the ethical mind is not a permanent condition. And finally, because if strong bad incentives exist, weakness of will may be fostered in previously ethical members. In this sense, despite not being a sufficient sole condition, both control and standardization are needed.

The objective of the *harmonized approach* is neither mere compliance with regulation nor is it the combination of ethical members but the creation of an authentic culture with an ethical basis.

Using a therapeutic simile, we have said that corporations, showing obvious symptoms of disease, have received first some palliative treatments from regulators. The development of better technical regulatory bodies has been important to attenuate or cover up some technical symptoms; however, compliance does not address the problem since it does not prevent the recurrence of the disease (Greer & Tonge, 2006). It helps boards and society to feel better about themselves and to maintain calm without necessarily being cured. Moreover, as well as positive consequences, in some cases, regulation has deformed the authentic levels of moral and technical exigency, not affecting reality but the perception. If the patient believes that he is cured, he will never overcome the causes of his sickness.

At the same time, we have shown that the *integrity approach* seeks to tackle the root of the problem by addressing the actor directly, that is, the moral person, in some sort of preventive gene therapy. There is indeed no objective assessment with which to detect the integrity of people. Therefore, we tend to look for approximations—for example, absence of a criminal record, adherence to some kind of creed, family situation, tasks, or positions held, and so on—that would enable the selection of people with a specific profile and the design of organizations that conform to a suitable idea of what is meant by integrity. This gene therapy, which could be effective in certain aspects, does not ensure the avoidance of the biases and errors characteristic of the human condition.

We have argued that preventive and palliative approaches, while both are necessary, are also incomplete on their own and thus we have proposed a *harmonized approach*. Continuing with the simile, it would be a sort of vaccine. With the human condition, we have inoculated bounded rationality and limited willpower and, on that basis, we build our own identity, which makes us aware of both our possibilities and our limitations in every moment and circumstance. For this reason, as a result of this analysis with a prudential basis, we constantly strive to improve our immune system—compliance mechanisms—and at the same time strengthen and promote our healthy habits, physical—command and control—and moral, both individual—integrity—and collective moral engagement (Shu & Gino, 2012; Shu et al., 2011), giving shape to prudent governance.

Hence, the harmonization of an approach of compliance with an approach of integrity into a culture of compliance provides a prudential environment, not only a normative framework. This conceptual paper has analyzed the AC—a typical regulatory instrument of compliance—to show the validity of the *harmonized approach*. Regulation states that members of an efficient AC should be qualified, independent, and diligent with no mention of any ethical aspects.

We reveal that these elements actually have ethical components that appear when they are integrated and working together in a prudential context. Thus, the expert, independent, and dedicated members of the AC would add a moral engagement to their technical engagement. Moral and technical engagement working together would enable a harmonized culture of compliance to be generated. The ethical consideration of compliance, far from subtracting from this, fosters efficiency in the long run, reinforcing governance and easing the practice of honesty of each member of the AC.

Several limitations of this study should be considered in future research in order to extend and expand its scope. For instance, the *harmonized approach* should be explored in other committees as well as in the board of directors, both theoretically and empirically; the inclusion of national elements of the culture of compliance should be considered, and the differences between corporate failures in the EU and non-EU (North American) setting be analyzed. Moreover, and in spite of the conceptual nature of our paper, the practical implementation of the *harmonized approach* in strategic decision making in corporations must be considered, at least in specific corporations.

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