

CHALLENGING CORRUPTION:

ENHANCING CATHARTIC INCENTIVES THROUGH EBIAF®

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Introduction

Anticorruption is a movement whose time has come. According to the World Bank, \$2.7 billion a day, or about \$1 trillion (\$1T) dollars a year, is paid in bribes in all industries ⁽¹⁾. The Bank's 2005 forecast in terms of turnover for the global Engineering & Construction (E/C) industry is over \$5T (U.S.) ⁽²⁾.

Some governments have enacted legislation to outlaw bribery – the Foreign Corruption Practices Act in the U.S. is an example – but enforcement has been spotty. For a long time, the industry ⁽³⁾ had no concerted plan to attack the problem. But, in the late-1990's several events happened that have given rise to the industry's most far-reaching effort to address corruption.

Corruption occurs when two or more individuals are abusing office by making bad decisions for personal gain under a strong conspiracy of silence (“Omerta”). The root cause of the problem is that corrupt individuals engage in conspiracies and making bad decisions. For the company of such corrupt executives, it all may end up in a night mere. Corrupt misconduct will jeopardize the company's good reputation and emerging ethical scandals may take the company without delay to the slippery slopes of decreased trust and share holder value destruction. At the receiving end of corrupt payments, senior officials fill their pockets with the (solicited) greed and execute very bad examples of public governance that will endanger the government in terms of reputation seriously.

Reputational risk is much more serious than financial risk, and all boards of directors should know that. It's apparent that over the past five years, businesses have become more proactive in seeking to protect themselves from future scandals. This has led some employees to believe that many companies are obsessed with ethics programs and compliance. Indeed, managers should understand they can be held responsible for their subordinates' actions. A way to drive home this message is “to let people know if their unethical behavior sabotages the business, they will be fired”.

Magnitude of the Problem

How big is the E/C industry worldwide? To put a number that big in perspective, look at some of the world's major economies. The estimated 2005 Gross Domestic Product (GDP) for the U.S. is \$12.5 T ⁽⁴⁾ Japan's 2005 GDP is estimated at \$4 T ⁽⁵⁾. Germany's 2005 GDP is estimated at \$2.5 T ⁽⁶⁾. The E/C industry is about 1/3 the size of the U.S.

economy. It is larger than Japan's economy and nearly twice the size of Germany's economy. The E/C industry is truly big business!

Numbers tell part of the story, but not all of it. Emerging trends are also major considerations. Two forecasts have strong implications for the potential for corruption in the future. The first forecast is that by 2015 – 8 years from now – 80% of the money spent on infrastructure in the world will be spent in places we describe as developing countries. A second forecast calls for 2/3 of the major cities in the world to be in those developing countries by 2020 ⁽⁷⁾.

When you look at the magnitude of the E/C industry, the amount of funds lost to corruption and the forecasts of where major E/C activities will be, you get a picture that can be interpreted as a growth scenario for corruption in the E/C industry. Corruption is a current, major problem with the potential (prospective?) to get much worse.

Corruption Kills

While the figures illustrate the huge financial loss caused by corruption, they do not illustrate the human cost. By diverting resources from inoculation programs, medicines, hospitals, and water and food supply projects, people die from preventable disease and hunger. In addition, corruption results in projects which are built to unsafe designs or which use dangerous construction methods, equipment or materials.

Quite simply, corruption kills. Corruption kills not only because money intended for the poor ends up in the pockets of greedy officials, but because the bribes set in motion a chain of harmful events – the selection of unqualified contractors, the gross inflation of costs, the failure to complete works, the delivery of substandard goods, or, too often, of nothing at all – that hamper development and add to unproductive debt. In fact, corruption and its progeny of fraud, waste, abuse and neglect are now widely acknowledged to be the single greatest impediment to the development of impoverished countries.

Just what is Corruption?

Corruption occurs in cases of abuse of office for personal gain and the E/C industry has a wide variety of corruption forms. The main ones are:

- Kickbacks/bribery
- Front companies
- Bid rigging/collusion
- Conflicts of interest

Government and project officials can divert funds from projects by demanding kickbacks from contractors in exchange for the award of a contract, the payment of invoices, or the approval of contract amendments or other services. This is most common way to steal because it is easy to accomplish, hard to detect and very lucrative. For example, the

standard 10% kickback demand on a routine \$50 million road rehabilitation project would yield \$5 million untaxed dollars. And this is from just one project; many corrupt officials manage many projects.

Another common form of corruption is project staff or owners secretly owning front companies that do business with the project, usually at inflated prices for poor quality services.

At times, project staffs convert project funds and assets directly to their own use. These transactions usually are relatively small compared to those described above, and include such unimaginative but remunerative offenses as:

- Embezzling funds directly from project accounts;
- Converting vehicles and computers to personal use;
- Using project funds to pay for vacations, buy cars or build houses, or
- Selling goods intended for the project, such as medicines, food or construction materials, for personal profit (perhaps through their front companies), and so on.

Contractors defraud projects (to recover the costs of their bribes and inflate profits) by overcharging for goods and services, charging for goods and services that are never delivered, substituting less expensive, lower quality materials for those called for in the contract, or billing lesser-paid employees at higher rates on consulting contracts.

Kickbacks and bribery are the two sides of the same corruptive coin. Kickbacks are *asked for* by someone in a position of power from someone seeking a favorable decision by the person in power. Bribes are *offered* to a decision-maker by someone seeking a favorable decision. Kickbacks can be sought by owners from engineers or constructors, by engineers from potential subcontractors, by constructors from potential subcontractors or material suppliers, by material or equipment suppliers from potential subcontractors, or by regulatory/ permitting agencies from engineers, constructors, material suppliers or equipment suppliers. Bribes occur in the opposite direction. Kickbacks and bribes result in funds earmarked for projects going into the pockets of individuals. As kickbacks and bribes replace quality in selection processes, project quality and reliability are lowered. The end result is that the people who need, and are relying on the project will be the ones who suffer.

The flow of kickback or bribe funds can be quite complex. Wire transfers or cash payments leave no trail – at least when used in combination - for auditors. International bank transfers can also be difficult to trace. In some countries, it is impossible to establish ownership of bank accounts or assets. Forged documents may be used to create seemingly legitimate paper trails. In some cases, middle men are used to facilitate the transfer of funds. It is often difficult to decipher legitimate business relationships with middlemen from illegitimate ones. One overarching attribute of kickback/bribery schemes is a strong conspiracy of silence among the participants. For all these reasons, kickback/bribery schemes have flourished for centuries, and continue to do so today.

Front companies are often newly established entities. They do not show a history of successful work. Often, they will offer diverse, disconnected services. The above could also describe a legitimate joint venture company (JV) formed for a project. The big difference between the front company and the legitimate JV lies in the ownership records. The front company has few records of ownership; the JV is fully transparent on ownership.

The reason for few ownership records is that the owners do not want to be known. They may be high-ranking government officials who would receive profits from the front company. Owners could also be officials in the Project Implementation Unit – who will have a voice in awarding work to the front company. A front company often acts as the “Local Agent” for a project, not one of the key producers of the work.

Bid rigging and collusion are other corrupt activities that can take a variety of forms. Owners’ personnel can participate by setting very short bid periods so only firms they have notified illegally about the upcoming bid have sufficient time to prepare a sound bid. Owners’ personnel can also exclude qualified firms from bid lists and only allow “favored” firms to compete.

Contractors may engage in collusion by making agreements on who will get each of a series of projects. In this way, the “designed winner” can submit an artificially high bid, while the others submit even higher ones. There can also be collusion between owner’s and contractor’s personnel. For example, a “favored” contractor may be asked to submit an artificially low bid to assure that it will get the project. During the course of the work, the owner’s staff will allow contract modifications and change orders that raise the contractor’s revenue, lower the contractor’s cost, or both. Bid rigging and collusion may also be parts of larger corruption schemes.

Finally, all types of conflicts of interest are forms of corruption. Conflicts of interest can range from per se conflicts – where a person has a direct personal stake in the outcome - to more camouflaged ones where friends and/or family members receive the unwarranted rewards. The way to minimize conflicts of interest is to require disclosures of all real and potential conflicts by all parties – owners, potential contractors (engineers or constructors, suppliers, and lenders) – to a project prior to the start of procurement activities.

During the progress of a project, or a series of project, there are often “red flags” we can see that may indicate corruption. Some of these indicators are:

- Recurring use of one company – prime contractor, sub-contractor, supplier, agent
- A close, personal (non-business) relationship among project parties
- The terms of reference in contracts are vague or incomplete
- Firms use false qualifications or show resumes of qualified people but use other less qualified staff on the project
- Firms use the same address or phone number
- A firm does business using a variety of names
- One firm does many, diverse tasks

Current Actions

Many members of the engineering/construction industry have decided to act. A big step is to improve the openness and transparency of the decision-making processes in all phases of a project:

- Procurement of the work and
- Performance of the work by all parties involved in a project – owner, engineers (lead and sub-contractors), constructors – prime and sub-contractors, material and equipment suppliers, lenders, and regulators.

The key members of the engineering/construction industry who have current action programs are: governments (who may be owners or regulators), engineers, constructors, lenders, evaluators, and professional organizations.

Governments around the world are tightening their legislation against corruption: The United Nations Convention against Corruption; the OECD Convention on Combating Bribery; the Inter-American Convention against Corruption; two Council of Europe Conventions on Corruption; two EU Conventions; the African Union Convention on Preventing and Combating Corruption; and the ADB OECD Anti-Corruption Action Plan for Asia and the Pacific. The most significant convention, due to both its scope and geographic reach, is the UN Convention which has been signed by 140 countries, and been ratified by 88. It came into force in December 2005. It requires:

- The development, implementation or maintenance of effective, coordinated anti-corruption policies;
- The establishment of transparent, competitive and objective procurement systems and public finance procedures;
- The criminalization of bribery, trading in influence, embezzlement, abuse of power, illicit enrichment, money laundering, and false accounting (applicable to both public and private sector);
- The establishment of independent and adequately resourced entities to fight corruption;
- International co-operation and extradition.

In order to comply with the obligations imposed by these conventions, many countries had to change their anti-bribery laws. In particular, all OECD countries were required by the OECD Convention to ensure that their laws made it a crime, prosecutable in the home country, for their companies and nationals to pay a bribe overseas. All OECD countries have now changed their law in this regard. Previously, an individual who paid a bribe overseas may have been confident that he would never be prosecuted. The country in which he paid the bribe may have had an ineffective prosecution system, and his home country may have had no jurisdiction over an act which took place overseas. Now that has changed. He may be prosecuted both in the country in which he pays the bribe, and in his home country.

International anti-money laundering regulations have been tightened, and bank secrecy laws have been relaxed. Though, it remains questionable whether corruptive transactions will be detected through this system. As a result, there is an increased likelihood that the payers and recipients of corrupt payments will be identified. In addition, convention obligations require countries to co-operate in the identification and recovery of corruptly obtained assets.

G 8

Many governments are also aware that effective anti-corruption action needs more than merely signing a convention or changing the law. In July 2005, the world's eight largest economies issued a G8 communiqué which committed the G8 nations to *“Reduce bribery by the private sector by rigorously enforcing laws against the bribery of foreign public officials, including prosecuting those engaged in bribery; strengthening anti-bribery requirements for those applying for export credits and credit guarantees, and continuing our support for peer review, in line with the OECD Convention; encouraging companies to adopt anti-bribery compliance programs and report solicitations of bribery; and by committing to co-operate with African governments to ensure the prosecution of those engaged in bribery and bribe solicitation”*.

Debarment Program

Debarment is becoming a more widely used government tool. It is a system under which companies or individuals who are found guilty of corruption are prevented from participating in future projects owned or funded by the debarring organization. Many governments operate a debarment system. For example, as a result of the EU Procurement Directives 2004, all EU member states were required, by 31st January 2006, to ensure that their laws provided for mandatory exclusion of a company from public sector and utility contracts if the company, or its directors, or any other person who has powers of representation, decision or control of the company, have been convicted of corruption, bribery, fraud, money laundering, cartels and specified other offences.

The OECD Export Credit anti-bribery working group, which comprises the export credit agencies of all OECD countries, issued in May 2006 its "Action Statement on Bribery and Officially Supported Export Credits". This requires all OECD export credit agencies to enhance their anti-corruption actions. Among the actions are requirements on export credit agencies to:

- encourage applicants for export credits to develop, apply and document appropriate anti-bribery management control systems;
- require applicants to provide undertakings that neither they, nor anyone acting on their behalf, has engaged, or will engage in bribery;
- verify whether applicants appear on an Multilateral Development Bank (MDB) debarment list, or are being investigated, or have been convicted, of bribery;
- require disclosure of agents and their commissions;
- obtain recourse from an applicant in the event of bribery.

The major international lenders have also been active in developing and implementing anti-corruption programs. In February 2006, the African Development Bank, Asian Development Bank, Inter American Development Bank, European Investment Bank, European Bank for Reconstruction and Development, the International Monetary Fund and the World Bank agreed to standardize their definition of corruption, to improve the consistency of their investigative rules and procedures, to strengthen information sharing, and to assure that compliance and enforcement actions taken by one institution are supported by all others. They also agreed to work together to develop concrete proposals to assist countries in strengthening their capacity to combat corruption, and to improve cooperation with civil society and other stakeholders and institutions with the goal of enhancing transparency and accountability.

In addition, all multi-lateral development banks operate debarment systems. The best known is that of the World Bank which has a large corruption investigation department, and which publishes a list of debarred individuals and organizations on its web-site.

Voluntary Disclosure Program

The World Bank has also developed its Voluntary Disclosure Program. This is a program that allows firms which have been involved in corrupt activities to confidentially describe their activities in detail in exchange for lack of debarment. The program is in its infancy, but holds promise as a tool to combat corruption.

We have discussed what companies and institutions are doing to address corruption in the E/C industry. The engineering societies around the world, whose members are individuals, not firms, are also acting to fight corruption. Several organizations have developed model codes of conduct and guidance to assist individual engineers improve their understanding of ethical practices and the damage and risks of corruption, and to enhance their disciplinary procedures.

The way ahead

By now, one may assume that simply ignoring corruption is the same as condoning it. Cooperative action is essential if corruption is to be prevented. Tackling corruption is not a competitive issue. Everyone (apart from the corrupt) will benefit if corruption is eradicated. A level playing field will be achieved, and companies will be able to compete and to perform free from the risks, unfairness and uncertainties which corruption imposes.

A simple, 4 part program will start positive action as a first step:

- Educate all those working in the profession on the true cost of corruption in their country
- Shine a bright spotlight on corrupt activities wherever you see them
- Make it socially unacceptable to be involved in corruption
- Educate the next generation of engineers, constructors, owners, government leaders, material and equipment suppliers and lenders on the true cost of corruption

Awareness of and need for ethical behavior

The increased awareness of and need for ethical behavior, the establishment of hotlines to report misconduct and greater use of ethics officers and written codes of conduct are making a huge difference. Employees should understand they will be accountable for their performance, and not just as it impacts their career advancement.

It's clear that companies that emphasize ethics throughout the cultural framework aren't just "doing the right thing" but ultimately find they are protecting the company's reputation and brand.

When scandals erupt, the damage to reputation can create a ripple effect, starting with an employee exodus. The inability to attract and retain talented employees is very expensive, and can affect loyalty, quality control and deadlines for completing initiatives. Add to the mix customer dissatisfaction, impact on stock price and loss of market share, and you have all four wheels falling off.

While boards are still coming to terms with their increased oversight responsibilities, this does not allow them to ignore ethical issues. How does a company build its culture to show its actions speak louder than words?

Ethics and Business Integrity Accountability Framework (EBIAF®)

Ethical culture cannot be separate from the rest of the organization, and top management must recognize and insist that all stakeholders adopt the same vision. Starting with the board of directors, everyone needs training to learn how to identify risks and develop strategies that promote ethical conduct and trust. If employees believe reporting bad news equates to failure, that organization is building a toxic culture⁽⁸⁾ that may have catastrophic consequences. Investing in a good corporate ethical climate is one of the most important long term investments that will create better corporate performance, sustainable continuity and increased shareholder's value.

Important primary conditions to prevent reputational damage and value destruction due to non-ethical behavior, is the willingness of the senior management to act as a role model and of employees to really commit to the organization's integrity rules. For that purpose extensive internal communication concerning business ethics and - integrity must take place. The Ethics and Business Accountability Framework - EBIAF® promotes in a structured manner the growth process resulting in a broad adherence to the organization's ethical and integrity rules.

Proactivity and encouragement

EBIAF® is focused on fostering ethical behavior and the prevention of misconduct to occur. The model basically anchors several readily established functions within the standing organization by beefing them up and making them highly interactive as part of a cyclical process paradigm. The first functions are laying robust groundwork for ethical behavior, (so-called ex-ante functions). The other (ex-post) functions are of a *reactive* nature and ensure that the organization handles instances of unethical behavior adequately.

The cyclical approach of EBIAF® fuels *an ongoing process of activities* that passes through the several functions time and over again and ideally starts at the proactive or encouragement functions including the Corporate Ethical Framework, Training and Outreach, Strategic Communication, Ethical Consultation and Ethics Officer Oversight at an aggregated level.

On the reactive or response side the organization continuously strives to independently detect unethical behavior as early as possible, to get internally observed or suspicion of unethical behavior reported, examine these reports against actual facts, apply an effective but fair sanctions policy and once again the Ethics Oversight Function in terms of analyses, measurements and surveys.

Dynamical process

The crucial follow up is to anchor the ‘lessons learned’ in the organization. Back at “square 1” the Ethical Framework and weakened organizational systems are adjusted based on lessons learned. Thereafter adaptation of the training curriculum follows. In terms of “and so on and so forth” the flow diagram will be entirely run through again and after the last step the ‘lessons learned’ will again be secured by means of the above described activities, to start again with adjusting the Ethical Framework.

Operation

Bottom line is that activities and results in the area of Business Ethics and Integrity are permanently brought to notice of management and employees. Due to this process employees emphatically experience the constructive way in which the organization handles all aspects of Business Ethics and - Integrity. As a result, a (increasingly measurable) positive effect is brought about in terms of increased commitment of management and employees to the Ethical program of the organization.

Aim

Organizations may benefit from EBIAF® to promote Ethics and Company Integrity as core values within the organization, limit integrity distortions and the risk for reputational damage and substantially limit possible negative personal consequences for (individual) executives as a result of integrity distortions and reputational damage.

Outcome

Culture is the leading risk factor comprising integrity and compliance in companies today. Too many times staff and management do not fully understand how their culture creates risks and how to mitigate them to stay out of trouble.

Unethical conduct doesn't happen in a vacuum. Good people may crack when their breaking point is reached. Or they feel entitled to slip because standards are not applied consistently throughout the organization.

Correct implementation of EBIAF® will result in making the organization an ethical workplace, a substantial mitigation of reputation risk, decrease of control costs and will eventually lead to value increase. This is the outcome of emerging culture changes in terms of:

- Significant larger commitment of employees to adhere to the ethical standards set within the organization;
- More intensive staff reporting pattern and less need for staff to invoke the whistle blower status;
- An open debate concerning ethical and integrity dilemmas;
- A more transparent business culture;
- Increased internal and external credibility of the organization;
- A more effective and efficient staff performance and
- Creation of additional (shareholders) value.

Managing ethics and business integrity has become an important ingredient for continuity (and shareholder value) of organizations. Regardless of how well Internal Control systems are managed and executed, they seem to fail where substantial mitigation of reputation risk and – damage is required. EBIAF® Dynamical Integrity Management is the appropriate answer to link Ethics management, Internal Control and Good (Corporate) Governance in order to increase corporate performance and to significantly reduce integrity risks and control cost in the total value chain.

NOTES

- (1) *Report on Corruption, World Bank Institute, April 2004*
- (2) *The Global Construction Study, Global Insights, 2006*
- (3) *Transparency International Bribe Payers' Index, 2002*
- (4) *U.S. Department of Commerce, Bureau of Economic Analysis*
- (5) *UN Global Compact 10th Principle*
- (6) *U.N. Data*
- (7) *A.T.Kearny, Inc.*
- (8) *2007, Financial Executive, a publication of Financial Executives International*

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