

**A Luncheon Forum co-hosted by the
Hills Program of the
Ramon V. del Rosario, Sr.-C.V. Starr Center for Corporate Governance of the
Asian Institute of Management and the
Philippine Business Leaders Forum**

***Corruption in the Private Sector: The Quiet Forces that Engender Corruption*
Mr. Roderick Hills**

My wife and I created a foundation to study corruption and governance matters 9 years ago and since then I have spent a significant part of my life on the subjects. An old friend of mine who is a colleague of our law professor son asked him why his Dad was too concerned, uptight he put it, about corruption. I am told that my son's answer was: Dad ran into corruption so much by accident, I guess he wants now to do it on purpose.

There is a little truth to that answer. I have had a whole lot of corruption accidents both in government and in business.

I came to the White House as Counsel to President Ford largely because I was offered a companion job of chairing a White House Council for Regulatory Reform, a subject that I had taught at Harvard. We did some good work at economic reform introducing legislation that eventually eliminated price regulation for trains, trucks and planes.

But all of our work was overshadowed by a Senate Investigation of the Central Intelligence Agency, the CIA and I represented the President in that investigation. Incredibly stupid, illegal and corrupt behavior of a few rogue agents occupied the headlines during the entire time I was in the White House.

Later a NY Times reporter commented that it I was the only person he knew that used the CIA as a cover to do something else.

I went to the SEC because of my same interest in regulatory reform. The President and Alan Greenspan, then the Chair of the Council of Economic Advisors, wanted the SEC to stop fixing the prices, the commissions, charged for buying and selling stock. They argued that competition would give us more efficient capital markets. The SEC did stop fixing commissions, the market did become more efficient, but to our enormous surprise we also eliminated a great deal of corruption.

Stock brokers had been bribing the fund managers to get business they could not get by price competition: dinners in NY or Paris, swimming pools in back yards and hookers in hotel rooms were happening because price competition was not permitted.

My other SEC surprise was that soon after I got there we discovered that a huge number, a couple hundred, of U.S. companies had been making questionable payments, bribes, to foreign officials.

Why did they do it?

Well the motive, of course, was to get some official to do something that may or may not have been legal that the official would not otherwise do.

Why so many?

The large number of bribes occurred because it was so easy then to do so. It was customary in those days for U.S. companies to have large private/secret bank accounts: kind of large petty cash accounts for CEO's. It was a convenience that was usually not abused. But far too many CEO's were tempted to use the money illegally because they could get away with it: to bribe, to make illegal political contributions or simply to steal the money.

Our answer was to take specific steps to get rid of secret bank accounts: by requiring companies to have internal controls, requiring auditors to report suspicious book entries to someone independent of the suspicion and requiring the NYSE to force its members to have independent audit committees so that the auditors would have someone to go with their suspicion.

I am not foolish enough to believe that we eliminated all the bribery of foreign officials by making it hard to maintain secret bank accounts, or that the bribery of fund managers has gone completely away because we have competitive commission rates. But I am certain that the elimination of those *corrupting influences* substantially reduced bribery.

Those two SEC experiences, and some corporate experiences that I will mention in a moment, have told me that bribery is not going to be reduced by passing a whole bunch of new laws. If the incentives for corruption are too strong or if corruption is too easy laws will not stop it.

There is a Wall Street Journal quip many years ago that sums up my point:

"They have already passed 10 million laws," said the Journal "to enforce the 10 Commandments and it did not work."

These experiences and some business problems caused Carla and I to fund the Program on Governance that we have at the Center for Strategic and International Studies ("CSIS") and to support similar programs here at AIM, at Yonsei University in Seoul, Tsinghua University in Beijing, MADE Business School in Mexico City will take us to Indonesia on Thursday to launch our 5th Program at the University of Indonesia.

When one of the Governance Center's addresses a governance/corruption problem we encourage it to do the research work that is necessary to identify those specific corrupting influences that exacerbate the problem and then to organize efforts to reduce those influences.

It's not that easy to define those influences. It often takes serious work by skilled researchers. A law background in such research is not as important as a background in economics, sociology or political science.

As I mentioned I have had some relevant corporate experience. Specifically, in the past 38 years I have been involved in 10 corporate train wrecks, including Mayflower Van Lines, Republic Pictures, Sunbeam Oster, Drexel Burnham and Waste Management. In hindsight I can identify a law, regulation or traditional practice that contributed to those train wrecks.

Let me talk about Enron and Waste Management. Enron you all know about. The Waste Management wreck, my problem, happened two years earlier. Arthur Anderson was the auditor for both.

What went wrong?

In both cases the auditors allowed management to publish financial statements that were terribly misleading. In the Enron case hundreds of millions of dollars of liabilities were not on the balance sheet and some assets were, by any common sense appraisal, way over priced.

In the Waste Management matter over \$3 billion of income was improperly recorded.

How could it have happened?

It happened because our regulatory system was over 70 years old. It was creaky and desperately needed repair. I like to say that anything over 70 years old is creaky and needs repair and I speak from very personal experience.

First, our financial statement had become obsolete. It was created in the time of bricks and mortar, when assets were tangible. If you paid \$100 for a table and told the auditors that it would last 10 years it was easy for the auditor to say that the 10 year estimate was fair and have you must take \$10 a year off your income.

But, today many assets are intangible and more and more we are required to "fair value" other assets. The best most honest corporate managers *have enormous discretion* in setting such values. If Enron said we have a contract to sell natural gas to California for 25 years and the present value of that contract is \$100 million it is not simple for the auditors to prove that the estimate is unreasonable. Under pressure from a big client far too many auditors yielded to management.

My point is that an absolute system that pretends that auditors can attest to precise earnings per share encourages managers to game the system with widely optimistic estimates and assumptions. The system is in effect a corrupting influence.

The Economist magazine made this point a few years ago in an article entitled "***Hard and Fast is not Fair and True***" the author argues that our standard financial statement has perpetuated:

"The brittle illusion of accounting exactitude that tends to collapse in times of economic strain. "

Second, while our financial statements were becoming obsolete our basic external audit was becoming a commodity with very little intrinsic value to managers. It is today more of a compliance tax than a management tool.

Auditors, as rule checkers, too often make no real effort to understand complex corporate transactions that can conceal real risks.

Our system is still creaky. Sarbanes-Oxley helped a bit with two of its provisions:

- First it tells both auditors and audit committees that they must look at all the alternatives that were open to management when it made its assumptions and estimates. And both of them, auditors and audit committees must conclude that management made fair choices.

- Sarbanes-Oxley also requires far stronger internal controls. And requires managers and external auditors to certify as to their efficacy.

Had these two provisions been in place earlier it is highly unlikely that the Waste Management and Enron frauds could have been maintained.

South Korea had an accounting scandal that dwarves those at Enron and Waste Management but the root causes of that scandal were somewhat different.

Daewoo, one of Korea's largest companies, collapsed when enormous accounting errors were disclosed. Its Chairman, Kim Woo Choong, once a national hero and recipient of international honors, became a criminal.

Our Governance Center at Yonsei University in Seoul has done an excellent case study of the Daewoo collapse. You can find it on our website.

Daewoo was a success story of monumental proportions created by the dramatic leadership of Chairman Kim and sparked by the industrial policies of the South Korean Government. Once a small textile company in 1976, it acquired heavy industry, shipbuilding and automobile companies with the aid of extraordinary state directed debt financing and became one of the largest conglomerates in the emerging world. But its exuberance caused its debt- equity ratio to be almost 600% by 1999.

In short Daewoo became an instrument of state industrial policy that lost all sense of economic reality. In his last years Chairman Kim used complex intercompany dealings to conceal much of Daewoo's debt until it literally overwhelmed the company in August of 1999.

There is no evidence that Chairman Kim profited by his fraud. His incentive may well have been simply to preserve a company that had created many jobs and was a symbol to the world of South Korea's economic success.

One might say that an overly aggressive state industrial policy seriously contributed to the resulting fraud. As you know far better than I there are government policies and practices in the Philippines that are incentives for corrupt behavior. In its 2008 report on "Doing Business in the Philippines" the World Bank Group points out as an example that it is much harder to start a business here than elsewhere. Your cities, says the World Bank Group, require between 15 and 23 separate procedures to start a business compared to an "average of 9 procedures elsewhere in East Asia and the Pacific."

"No wonder" says the report "that entrepreneurs in the Philippines resort to intermediaries who can speed up the process with informal dealings."

The report makes a similar point with respect to licensing generally and to property registration.

Please don't think I am picking on the Philippines. The phenomenon of corruption caused by faulty or heavy-handed regulation is worldwide. In the past few years in Washington, D.C. approximately 20 school officials have recently been convicted of stealing money from a school system that has a hopelessly outdated regulatory body.

I offer all of the above simply to explain that the effort of our Governance Centers is not to find criminals or pass more laws to forbid conduct that is already prohibited.

Our objectives are:

- To cause a broader understanding among business, political and academic leaders that we do not know enough about corruption to develop more effective measures to reduce it; and
- To encourage the kind of research that can cause such measures to be adopted.