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Look before you leap
Navigating risks in emerging markets

Fifth annual survey

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Executive summary

As companies continue to expand their activities in emerging markets — to produce products, deliver services, and sell to customers in these markets — many executives are concerned over compliance and integrity-related risks in these locations, which they believe are growing. Yet, few executives are highly confident that their companies have effective processes in place to identify and manage these risks when making investments or engaging third parties in emerging markets.

These are some of the key findings of Deloitte Financial Advisory Services LLP's fifth annual *Look Before You Leap survey* (the "*Survey*"), which solicited the views of 126 business executives on the approaches their companies are taking to address compliance and integrity-related risks in emerging markets. Survey participants represented a wide range of industries including financial services (29 percent), manufacturing (25 percent), and information technology and telecommunications (12 percent). Roughly three quarters of participating companies were headquartered in the United States, with other companies headquartered in Canada, Europe, Asia, and Latin America.

Many companies are investing in emerging markets through mergers and acquisitions (M&A) as well as by locating company-owned facilities in those markets ("Greenfield investment"). In addition to expanding their footprint directly, many companies are increasingly engaging third parties located in emerging markets — such as vendors and a variety of other third parties including service providers, sales agents, distributors, channel partners, and intermediaries.

The benefits of expanding into emerging markets can be significant to lower costs, tap a wider pool of skilled labor, improve the ability to respond quickly to changes in demand, and gain access to new customers. Yet, the compliance and integrity-related risks can also be significant. Before investing or engaging third parties, companies should consider implementing processes to manage risks such as corruption, money laundering, terrorist financing, connections to organized crime, criminal activity, and violations of economic and trade sanctions.

Given the potential for compliance risks in emerging markets, companies should carefully conduct due diligence before making investments or engaging third parties and should consider performing ongoing due diligence of existing business relationships and third parties. As enticing as opportunities in emerging markets may be, the Survey results suggest that "look before you leap" should be the watchword as companies plan their emerging market strategies.

Some of the key survey findings include:

- Seventy percent of executives said they were extremely or very concerned about compliance and integrity-related risks when their company conducts business in emerging markets, while 71 percent believed these risks had grown over the last two years (Page 3).

- *Bribery of government officials*[1] was the issue ranked as the greatest compliance and integrity-related risk by 40 percent of executives, while 26 percent placed *commercial bribery or kickbacks* as their top concern (Page 5).

[1] Specific Survey responses are in italics.

- Most executives were not very confident in the ability of their company to manage compliance and integrity-related risks. Only 38 percent of executives were extremely or very confident that their company had effective processes to identify and mitigate these risks when conducting mergers and acquisitions, while 34 percent had this level of confidence when their company made a Greenfield investment. With regard to third-party relationships, only 40 percent of executives were extremely or very confident in the ability of their company to manage these risks when engaging vendors, and 36 percent were this confident when their company worked with third-party agents (Page 5, Page 9).

- Due diligence is more common when companies consider investment than when they engage third parties. Seventy-one percent of executives said due diligence is always or almost always conducted by their company before conducting an M&A transaction or making a Greenfield investment. In contrast, only 43 percent of executives said their company always or almost always conducts due diligence before engaging vendors, while 49 percent said this was the case when engaging third-party agents (Page 10).

- Seventy two percent of executives said their company uses an initial risk assessment to determine the appropriate level of due diligence (Page 10).

- Only about half of the executives said their company conducts an extensive examination during due diligence of the possibility of bribery of government officials or of commercial bribery when considering M&A transactions or Greenfield investments in emerging markets or when engaging third parties (Page 11).

- Among the challenges when engaging third parties in emerging markets, 45 percent of executives ranked *adequately verifying information provided by business partners and third parties* as one of their company's top challenges. Other issues that were each ranked among the top three challenges by roughly one third of executives were *conducting timely and sufficient due diligence, lack of required skills and knowledge among employees,* and *securing qualified local professionals and firms to gather relevant information* (Page 12).

Significant concerns over compliance and integrity-related risks

Managing compliance and integrity-related risks in emerging markets is a major concern for many companies. When executives were asked how concerned they were about these risks when their company conducts business in emerging markets, 70 percent said they were either extremely or very concerned. (Figure 1) Further, executives believe these risks have been growing. 71 percent of executives believed compliance and integrity-related risks in emerging markets had increased over the last two years, while only nine percent thought these risks had decreased.

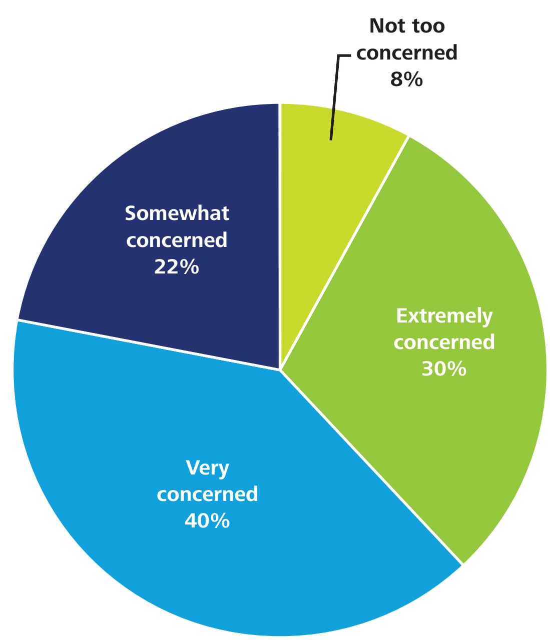
The concern felt by most executives in the Survey is consistent with the perceived levels of public-sector corruption in many major emerging markets based on the Transparency International's Corruption Perception Index. The Transparency International's Corruption Perception Index ranks 182 countries based on perceived levels of public-sector corruption such as bribery of public officials and the effectiveness of government anticorruption efforts.[2] While the highest-ranked countries are overwhelmingly developed countries, most of the major emerging markets are ranked below 70th.

The 48 enforcement actions under the U.S. Foreign Corrupt Practices Act (FCPA) brought by the Department of Justice and the Securities and Exchange Commission in 2011 were fewer than the 74 in 2010. However, both figures were far above the five to 15 enforcement actions each year between 2004 and 2006.[3]

Another source of concern may be the whistleblower provision of the Dodd-Frank legislation. Under the legislation, a whistleblower who voluntarily provides the Securities and Exchange Commission with original information about a violation of federal securities law that leads to a successful enforcement action is entitled to receive 10 percent to 30 percent of the penalties assessed.[4]

Given the reputational and financial risks involved in investing in emerging markets, one might expect that boards of directors and senior management would be actively involved in overseeing activities to manage these risks. Yet, according to the Survey this is often not the case. Only 47 percent of executives said their C-suite was very involved in overseeing their company's activities on these issues, while 39 percent said the same about their board of directors.

Figure 1
Concern about compliance and integrity-related risks in emerging markets



[2] Corruption Perceptions Index 2011, Transparency International, 2011, http://cpi.transparency.org/cpi2011/results/

[3] "2011 Year-End FCPA Update," Gibson Dunn, January 3, 2012, http://www.gibsondunn.com/publications/Documents/2011YearEndFCPAUpdate.pdf

[4] "The Dodd-Frank Whistleblower Provisions: Considerations for Effectively Preparing for and Responding to Whisteblowers," Cadwalader, Wickersham & Taft LLP, May 26, 2011, http://www.cadwalader.com/assets/client_friend/052611DoddFrankWhistleblowerProvisions.pdf

Bribery leads the list of risks

Executives see a variety of risks in emerging markets, but according to the Survey they are most concerned about bribery. Roughly three quarters of executives ranked *commercial bribery or kickbacks* as one of the top three compliance and integrity-related risks when conducting business in emerging markets, while a similar percentage ranked *bribery of government officials* among the top three. (Figure 2) However, 40 percent of executives considered *bribery of government officials* to be the single greatest risk when doing business in emerging markets.

While the FCPA prohibits bribery of foreign government officials, other countries also have antibribery laws that apply to commercial bribery. For example, in Singapore, the Prevention of Corruption Act also prohibits bribery of both private individuals and public officials.[5]

The 2010 UK Bribery Act ("the UK Bribery Act"), which took effect on July 1, 2011, prohibits offering, requesting, or receiving bribes involving commercial organizations. The UK Bribery Act prohibits commercial bribery that occurs anywhere in the world, provided the organization is incorporated or formed in the UK or carries on business in the UK. However, the quality of a company's compliance program is an important consideration in defending against an alleged violation of the UK Bribery Act. According to guidance provided by the UK Ministry of Justice, "It is a full defence for an organization to prove that despite a particular case of bribery it nevertheless had adequate procedures in place to prevent persons associated with it from bribing."[6] Thus, in addition to potentially reducing the likelihood that corrupt behavior will take place, it appears that companies that implement effective compliance programs may also have an improved defense if they are cited for an instance of bribery that occurs despite their best efforts.[7]

In the Survey, 56 percent of executives said the UK Bribery Act would lead their company to conduct more detailed compliance and integrity-related risk assessments than before, although only 16 percent expected their company to conduct assessments that were much more detailed.

Almost half of the Survey respondents ranked *violations of economic and trade sanctions*, and nearly 40 percent ranked *money laundering*, among the top three risks in emerging markets. (Figure 2) For both these issues, roughly half of companies reported conducting extremely or very extensive due diligence before conducting mergers and acquisitions or Greenfield investments in emerging markets. (Figure 4)

With regard to sanctions, the perception of risk may be a reflection of the increase globally in economic and trade sanctions. Yet despite the risks, only 12 percent of executives said they were very confident that their company's third parties in emerging markets would comply with the increased sanctions.

[5] "The Prevention of Corruption Act," Legal Update, Drew & Napier LLC, April 26, 2011.

[6] The Bribery Act 2010: Guidance about commercial organisations preventing bribery, UK Ministry of Justice, http://www.justice.gov.uk/downloads/legislation/bribery-act-2010-guidance.pdf

[7] Deloitte Financial Advisory Services LLP neither provides legal services nor engages in the practice of law.

Figure 2
Greatest compliance and integrity-related risk concerns in emerging markets

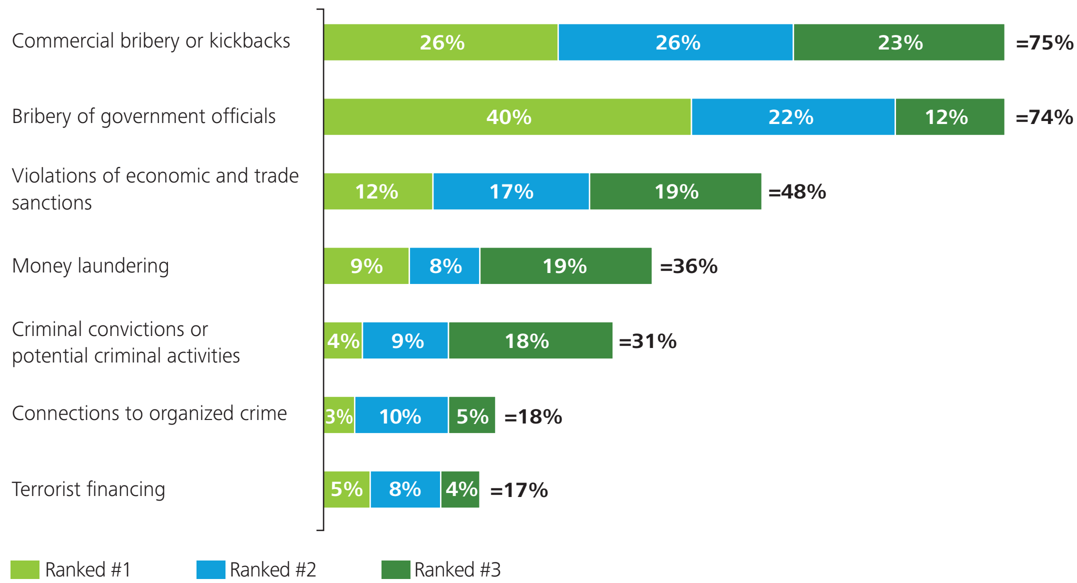
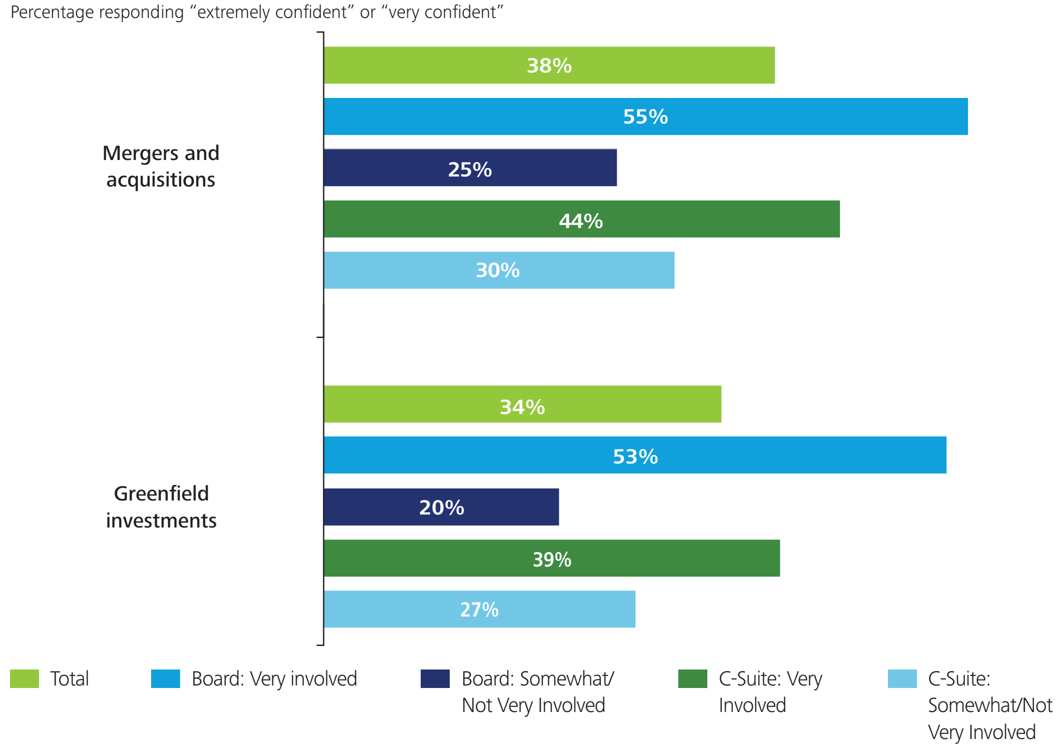


Figure 3
Confidence in effectiveness of processes to identify and mitigate compliance and integrity-related risks when investing in emerging markets
Percentage responding "extremely confident" or "very confident"



Key role of due diligence before investing

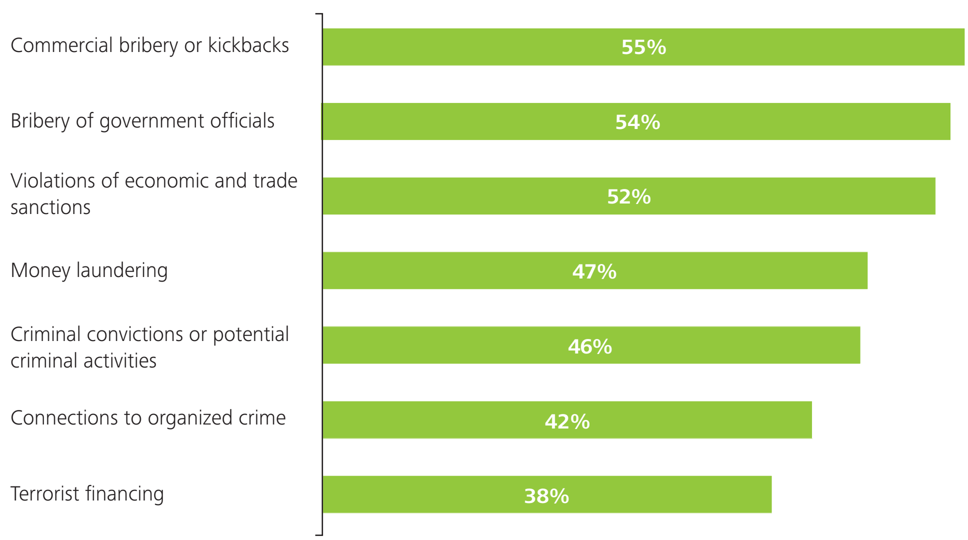
Many of the companies participating in the Survey are likely to invest in emerging markets in the coming years. Forty one percent of executives thought it was extremely or very likely their company would execute a M&A transaction in emerging markets over the next two years, and this figure rose to 56 percent among executives from companies with $1 billion or more in annual revenues. Greenfield investments were anticipated to be somewhat less common — 28 percent of executives thought it was extremely or very likely their company would open a company-owned facility in emerging markets over the next two years, including 44 percent of executives from companies with $1 billion or more in annual revenues.

However, relatively few executives in the Survey were highly confident in their company's ability to manage compliance and integrity-related risks when investing. Only 38 percent of executives were extremely or very confident in the effectiveness of their company's processes to identify and mitigate these risks during mergers and acquisitions, while 34 percent had this level of confidence when their company makes Greenfield investments. (Figure 3) Companies appear to have more effective programs when senior management and the board of directors are involved in overseeing the company's activities. Among executives who reported that their board of directors was very involved in overseeing these issues, 55 percent said they were extremely or very confident in the effectiveness of their company's processes to manage risks when conducting mergers and acquisitions in emerging markets, compared to 25 percent of those who said their board was less involved. Similarly, 44 percent of executives who said their C-suite was very involved in overseeing these issues were extremely or very confident in their company's ability to manage these risks when conducting M&A deals compared to 30 percent of executives at companies where the C-suite is less involved.

Figure 4

Level of due diligence when conducting mergers and acquisitions or making Greenfield investments in emerging markets

Percentage responding "extremely extensive" or "very extensive"

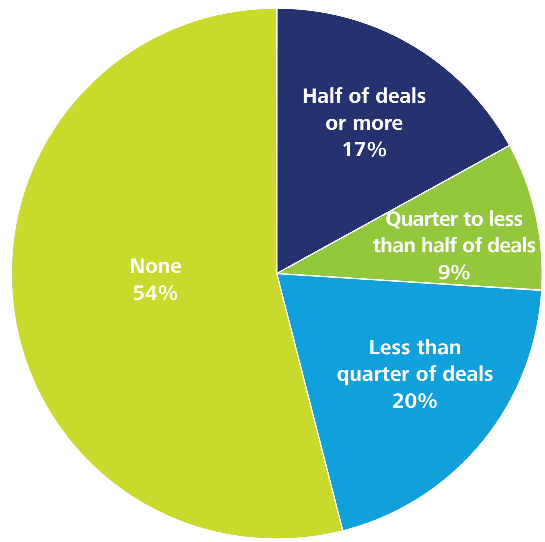


Note: For companies that conduct different levels of due diligence based on an initial risk assessment, executives were asked how extensive is the assessment of these issues for deals or investments in emerging markets when the company has determined there is significant compliance and integrity-related risk.

In managing these risks, the Survey suggests that due diligence is standard practice at most companies. Seventy one percent of executives said their company always or almost always conducts due diligence before making M&A transactions or Greenfield investments in emerging markets. However, due diligence into specific risks is often not extensive. Despite the fact that *bribery of government officials* and *commercial bribery or kickbacks* were ranked as top risks in emerging markets, only a little more than half of the executives said their company conducts an extremely or very extensive assessment of these issues during due diligence when considering mergers and acquisitions or making Greenfield investments. (Figure 4) Similarly, about half of the executives said their company conducts an extremely or very extensive assessment during due diligence of *violations of economic and trade sanctions, criminal convictions or potential criminal activities,* or *money laundering*. One explanation for this may be the business pressure to quickly complete a M&A transaction or open a new company operation.

Yet, according to the Survey companies that do probe into these and other issues often identify cause for concern. Among executives at companies that had considered potential M&A transactions in emerging markets over the last two years, 46 percent reported that potential deals had been halted due to compliance and integrity-related findings during due diligence. (Figure 5)

Figure 5
Potential M&A transactions in emerging markets halted over last two years due to compliance and integrity-related findings during due diligence
Base = Respondents at companies that considered potential M&A transactions



Risks posed by global supply chains

Based on Deloitte's experience, supply chains have expanded as companies have sought to drive down costs and increase their operational capabilities and flexibility. In addition to cost considerations, companies also find that employing third parties can help increase their flexibility to run operations around the clock by taking advantage of time zone differences and to quickly scale up operations when demand rises. Third parties can also help a company gain access to a wider pool of skilled professionals including professionals with an understanding of the local market, which can be important when conducting research and development for new products and when selling products or services to local customers.

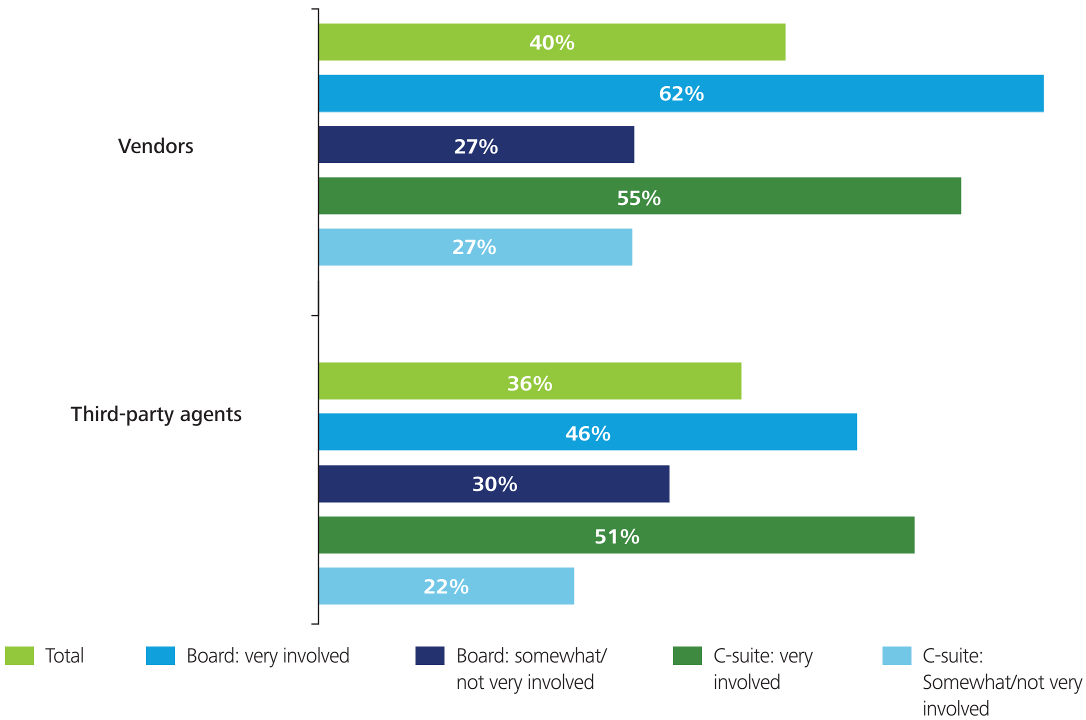
Major companies often engage thousands, or even tens of thousands, of third parties — vendors that manufacture products or components as well as third-party agents and distributors that help sell and deliver products and services to customers.[8] Although the activities of third parties are not under a company's direct control, unethical behavior by one of a company's third parties can result in legal enforcement actions under the FCPA and other anti-bribery statues, as well as garner negative media coverage resulting in reputational damage. Relatively few executives in the Survey were very confident in their company's processes to manage risks among third parties. Only 40 percent of executives were extremely or very confident in the effectiveness of their company's processes to identify and minimize compliance and integrity-related risks among their company's vendors in emerging markets, while 36 percent of executives had this level of confidence regarding third-party agents. (Figure 6) As with investments, executives in the Survey at companies where the board of directors and C-suite are involved were more likely to feel confident in their programs. Sixty-two percent of executives at companies where the board is very involved were confident in their company's ability to manage these risks when working with vendors in emerging markets compared to 27 percent of executives at companies where the board is less involved. There was a similar pattern with C-suite involvement; executives at companies where the C-suite is very involved in overseeing these issues were more confident in their company's ability to effectively manage these risks.

[8] "Concentrated Supply Chains Are High Risk," LogisticsToday, June 15, 2009
http://www.cvmsolutions.com/sites/default/files/whitepaper/concentrated-supply-chains-are-high-risk.pdf

Figure 6

Confidence in effectiveness of processes to identify and minimize compliance and integrity-related risks among third parties in emerging markets

Percentage responding "extremely confident" or "very confident"

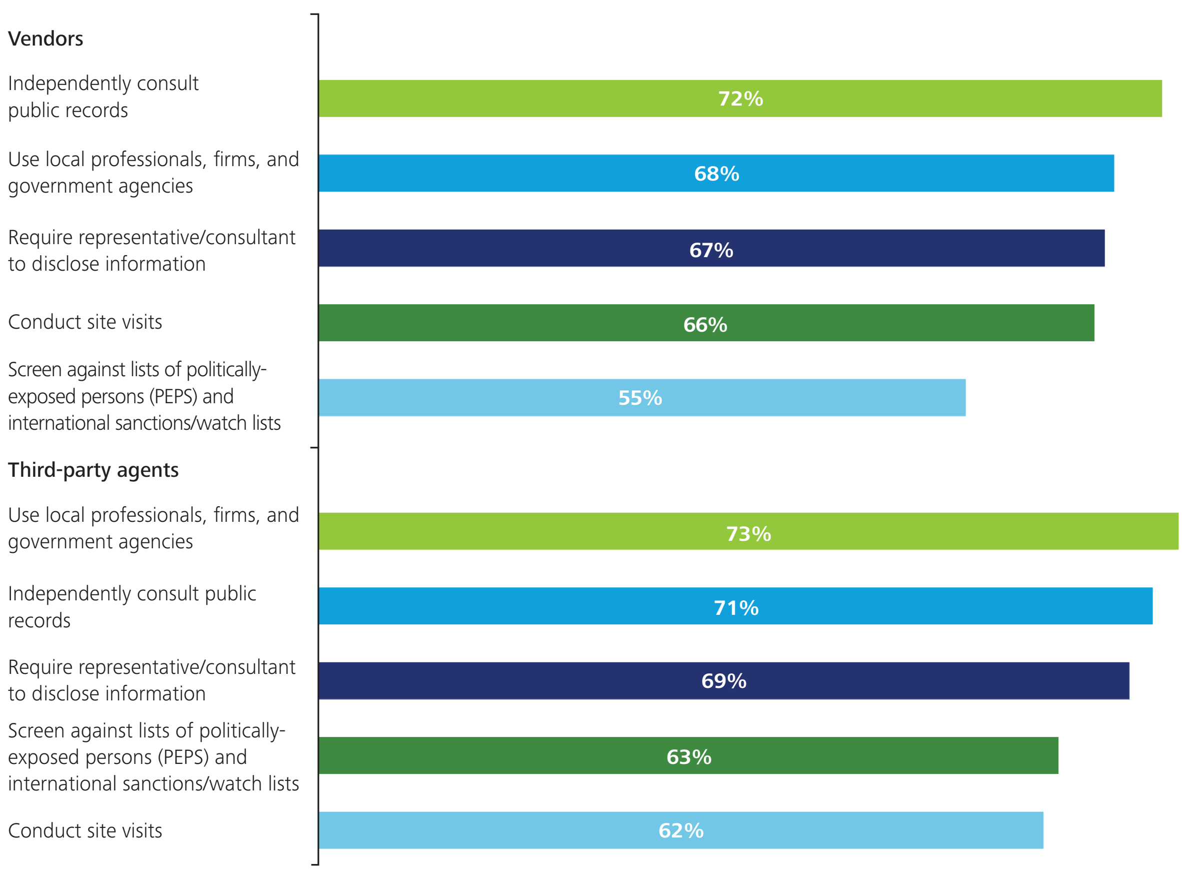


Lack of extensive due diligence of third parties

Almost three quarters of executives in the Survey said their company conducts an initial risk assessment before engaging a third party to determine if compliance and integrity-related due diligence is needed and, if so, what level of scrutiny is appropriate. Among companies that conduct initial risk assessments, most executives said their company examines accounts payable (87 percent), the volume of sales placed through sales agents and other third parties (82 percent), and the volume of sales to government entities (65 percent).

Many companies do not conduct compliance and integrity-related due diligence as standard procedure when engaging third parties. Less than half of the executives in the Survey said their company always or almost always conducts due diligence in emerging markets before engaging a new vendor (43 percent) or before engaging a new third-party agent (49 percent). Despite the fact that less than half of the companies routinely conduct due diligence before engaging new vendors or third-party agents in emerging markets, roughly three quarters of executives said their company conducts ongoing due diligence of existing third parties. However, only about one quarter said their company does so annually, while roughly half said this is only done every two years or less often.

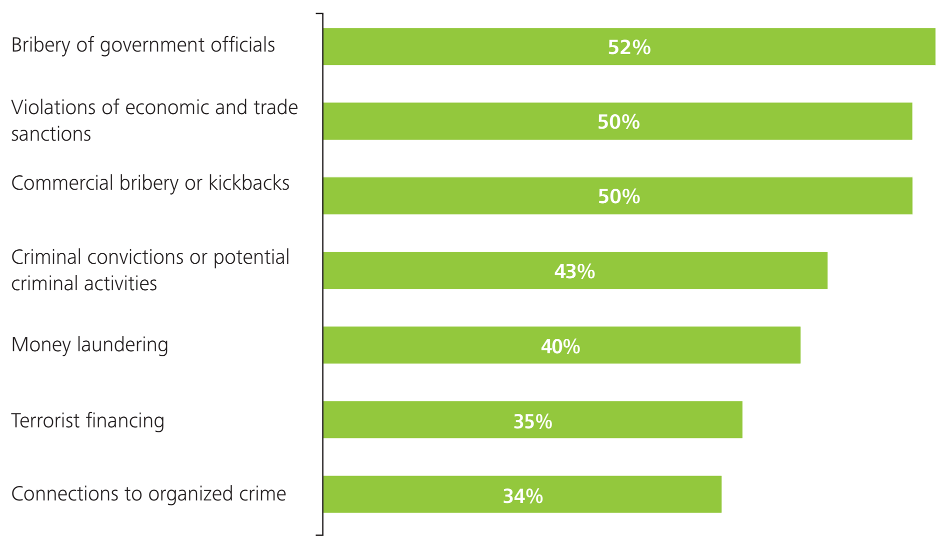
Figure 7
Due diligence activities for third parties in emerging markets on compliance and integrity-related risks



Most executives reported that several activities were used by their company when conducting due diligence on third parties. (Figure 7) For vendors, almost three quarters of executives said due diligence activities included *independently consult public records* (to verify ownership, to identify government associations, and to discover any unfavorable information) (72 percent). Roughly two thirds of executives reported that they *use local professionals, firms, and government agencies* (to check business references and conduct inquiries regarding business practices and reputation); *require representatives/consultants to disclose information* (such as beneficial owners, proof of incorporation, prior adverse information, or government connections); and c*onduct site visits*. For third-party agents, the most common due diligence activities are *use local professionals, firms, and government agencies and independently consult public records*. The least common method for both types of third parties was *screen against lists of politically-exposed persons ("PEPS") and international sanctions/watch lists* (such as by OFAC).

As was the case with due diligence of potential M&A transactions, many companies fail to conduct extensive assessments of many significant issues. Only about half of the executives said their company conducts an extremely or very extensive assessment during due diligence *of bribery of government officials, violations of economic and trade sanctions, or commercial bribery or kickbacks*. (Figure 8) Even fewer companies conduct extensive due diligence on such issues as *criminal convictions or potential criminal activities, money laundering, terrorist financing, or connections to organized crime*. The fact that many companies do not closely assess these key risks may be due to the scale and complexity of the task. Despite the challenges, however, failing to investigate these issues when engaging a third party in emerging markets leaves a company vulnerable to significant legal and reputational risks.

Figure 8
Extent of assessment when conducting due diligence on third parties in emerging markets
Percentage responding "extremely extensive" or "very extensive"



Note: For companies that conduct different levels of due diligence based on an initial risk assessment, executives were asked how extensive is the assessment of these issues related to third parties in emerging markets when the company has determined there is significant compliance and integrity-related risk.

Challenges in vetting third parties

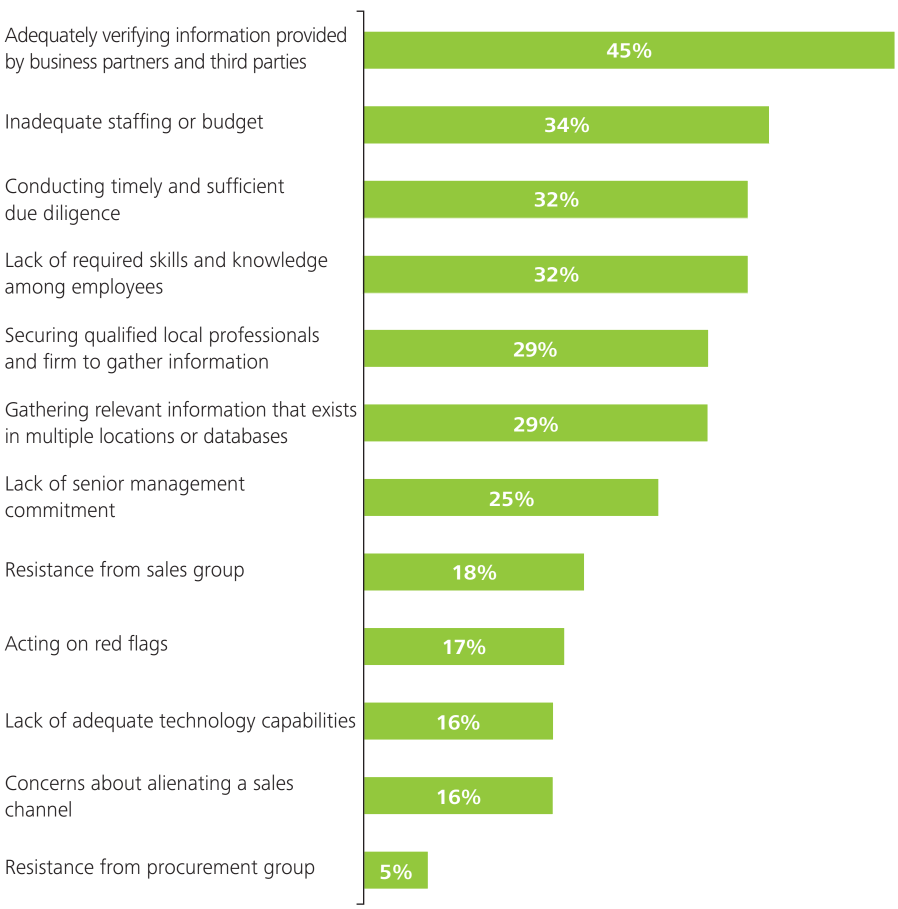
Executives in the Survey reported a number of challenges in their companies' efforts to identify and manage compliance and integrity-related risks among third parties. Leading the list was *adequately verifying information provided by business partners and third parties,* which was ranked among the top challenges by 45 percent of executives. (Figure 9) Some third parties may submit incorrect information, either accidentally or in some cases intentionally by maintaining an inaccurate set of financial records for public consumption. Analyzing and confirming the information provided by a third party can be time consuming, and can be difficult given the large number of third parties that many major companies work with. In fact, the second highest-rated challenge was *inadequate staffing or budget* (34 percent). A number of other issues were each ranked among the top challenges by roughly one third of executives including *conducting timely and sufficient due diligence, lack of required skills and knowledge among employees, and securing qualified local professionals and firms to gather relevant information.*

One quarter of executives cited *lack of senior management commitment* to compliance among their top challenges in managing these risks. As noted above, only 47 percent of executives said their company's C-suite was very involved in overseeing activities to manage these risks. The active involvement of senior executives is often critical to secure the resources needed for an effective program as well as to set the "tone from the top" by communicating the importance to the company of ethical behavior among both employees and third parties.

Figure 9

Challenges in identifying and minimizing compliance and integrity-related risks with third-parties in emerging markets

Percentage of respondents who ranked issue among top three challenges



Conclusion and recommendations

There has been an increasing focus on the ethical behavior of companies — and their third parties — by enforcement agencies, investors, and the general public. Working to ensure ethical behavior can be particularly difficult for multinational companies when it comes to their third parties in emerging markets such as vendors, business partners, licensees, contractors, and service providers. The scale of the task is often enormous since major companies can sometimes contract with tens of thousands of third parties. Yet, companies often face significant legal and reputational risks if one of their third parties engages in corrupt activities.

Companies should consider using a consistent and scalable process for assessing such risks across all their third-party relationships. Given the number of third parties, a risk-based approach is important to consider. Companies should consider assessing the compliance and integrity-related risks presented by each third party — both new third parties being considered and also existing third parties — and then consider conducting more intensive due diligence on those presenting higher risk. More in-depth due diligence investigations can analyze public record information, search media coverage, and conduct interviews to help determine if there is evidence of ethical concerns such as conflicts of interest, a record of bankruptcy or solvency issues, counterfeiting, use of child labor, product safety problems, links to organized crime, money laundering, or bribery.

A rigorous, risk-based approach can help to minimize the potential for compliance and integrity-related issues among a company's third parties. In the event such issues do arise, companies that have employed a rigorous, risk-based approach will be better positioned to demonstrate that issues have occurred despite the existence of a robust compliance and integrity-related risk program.

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