

India – Fraud & Corruption Insight May 2012
White Paper

i-fact@analysis, Inc.

India / Due Diligence Challenges For U.S. Companies

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India Presents Remarkable Business Opportunities for U.S. Companies by Virtue of its Sheer Size and Growth

There are multiple challenges that must be addressed as an integral part of an organizations compliance strategy given India's unique cultural and governmental intricacies. Corruption poses a FCPA compliance risk in India. There is also a heightened risk for other forms of financial fraud against U.S. companies operating in India.

As U.S. companies continue to expand globally, protecting their assets, reputation and workforce grows in importance. Today's economic conditions pose additional challenges and make it more important than ever that risk programs are leveraged as cost-effectively as possible to meet business objectives. The Indian economy is ranked 12th in the world in terms of GDP and is the fastest growing after China. India is expected to continue along the same trajectory, with consistent growth rates between 4-7%, which will position it as the 8th largest economy by the year 2025. These statistics and projections provide U.S. companies a solid platform for growth.

Multinational business is the key to the future for many U.S. companies and is often the main opportunity for growth. In some instances, the size of a company's multinational employee base is equal or surpasses that of their U.S. based employee population. ***Along with globalization comes increased risk.*** U.S. based companies have to ensure their policies and programs are compliant with current government regulations. The advent of the Sarbanes-Oxley Bill and increased enforcement of the Foreign Corrupt Practices Act by the Justice Department have imposed stricter accounting and financial controls on companies, escalating the need for financial transparency.

Certain countries expose U.S. companies to a high level risk of corruption. According to the Association of Corporate Counsel, "China, Brazil, India and Mexico are well known corruption risk. There is a lot of corruption in these countries, but it pales in comparison to the pervasive illegal activity in countries such as Russia, Vietnam, Nigeria and Pakistan." ***Conducting proper due diligence for U.S. companies in these countries is key to their success, ensuring profitable return on investment and building shareholder value.***

In 2010 alone, 52 individual businesspeople were indicted, sentenced, or were convicted and awaiting sentencing for FCPA violations. *Ten years ago FCPA prosecutions were rare.* Since 2008, the government has had approximately 150 FCPA investigations at any one time and brings approximately 40 cases each year. Lately cases have been divided almost equally against companies and individual company managers and/or employees. ***The government has stated there is a perception the FCPA hasn't any teeth until they see violators going to jail*** and they are doing a good job in making that happen.

The Department of Justice, SEC and FBI have well-staffed units dedicated to FCPA investigations and prosecutors are steadily building expertise. ***FBI agents are assigned overseas to investigate specific industries and countries.*** In 2010 the SEC established a dedicated FCPA Enforcement Unit with offices in Washington, DC and San Francisco.

In 2010 the total amount of penalties imposed by the Department of Justice and the Securities & Exchange Commission for violations of the FCPA was \$1.8 billion. According to the DOJ the Criminal Division's Foreign Corrupt Practices Act imposed \$1 billion of that total amount.

"In the Criminal Division, we have dramatically increased our enforcement of the Foreign Corrupt Practices Act in recent years.... We recently promoted a new head of the Section's FCPA Unit and two assistant chiefs, and we have also increased the number of line prosecutors in the Unit, attracting high caliber attorneys with extensive experience—including Assistant U.S. Attorneys with significant trial and prosecutorial experience and attorneys from private practice with defense-side knowledge and experience. These changes have significantly increased our FCPA enforcement capabilities." – Assistant Attorney General Lanny Breuer (Jan. 2011)

FCPA Current Enforcement Actions Related To India

Kraft Foods

Kraft Foods, a food and beverage company, has disclosed that it is currently being investigated by the SEC in connection with a facility in India that was part of its \$19B acquisition of Cadbury in 2010. Kraft has disclosed that the SEC wants information about its "dealings with Indian governmental agencies and officials to obtain approvals related to the operation" of the India plant.

Avon Products

Avon Products, a cosmetics, perfume, and toy seller has disclosed that the SEC has issued a formal order of investigation into possible violations of the FCPA. According to Avon, the investigation is focused on expenses and accounting for travel, entertainment, gifts, use of third party vendors and consultants, and related due diligence, joint ventures, and acquisitions, and payments to third-party agents and others.

FCPA Enforcement Actions Related To India

Diageo (2011)

- Diageo is one of the world's largest producers of alcoholic beverages such as Johnnie Walker and Windsor Scotch whiskeys.
- From 2003 to mid-2009, Diageo's Indian subsidiary made a number of illicit payments to government officials through third parties totaling an estimated \$1.7M.
- Diageo settled with the SEC for \$16M including \$11.3M in disgorgement, prejudgment interest of \$2.1M, and a further penalty of \$3M. The DOJ was not involved in this matter.

Pride International (2010)

- Pride International is an oil and gas service company. Pride's Indian subsidiary paid \$500K to judges of the Indian Customs, Excise, and Gold Appellate Tribunal for a favorable determination in a customs duties and penalties dispute. The estimated value of the favorable decision was approximately \$1M.
- Pride's Indian subsidiary pleaded guilty to criminal charges in the United States. Pride International and the Indian subsidiary settled with the SEC and agreed to pay a \$32M criminal penalty. Pride International settled similar civil charges with the SEC and agreed to pay disgorgement of \$19.3M plus pre-judgment interest of \$4.2M.

Control Components, Inc. "CCI" (2009)

- CCI designs and manufactures valves used in the power, oil and gas, and nuclear industries. CCI made payments of at least \$4.9M from 2003 – 2007 to employees of state-owned companies in several countries, including in India to the Maharashtra State Electricity Board.
- CCI pleaded guilty to criminal charges and paid an \$18.2M fine.
- Additionally, the company was placed on organizational probation for three years and ordered to create and implement a compliance program and retain an independent compliance monitor for three years.

Westinghouse Air Brake Technologies (2008)

- WABTEC manufactures brake subsystems and related products for locomotives, freight cars, and passenger transit vehicles. From 2001 through 2005, WABTEC's subsidiary paid approximately \$137K in cash to the Indian Railway Board to obtain contracts, schedule inspections, obtain certificates, and avoid tax audits
- WABTEC and its subsidiary entered into settlement agreements with the DOJ and the SEC. WABTEC paid a \$300K criminal penalty, \$288K in disgorgement of profits including pre-judgment interest, and \$89K in civil penalties (a total of approximately \$677K).

Dow Chemical (2007)

- Dow Chemical is one of the world's largest chemical manufacturers; its Indian subsidiary manufactured and marketed pesticides and other products. The subsidiary paid an estimated \$200K in payments and gifts to Indian government officials. Payments were made to a Central Insecticides Board official, state inspectors, and other officials. The subsidiary also made improper payments for gifts, travel, and entertainment to Indian government officials.
- Dow settled with the SEC and agreed to pay a \$325K civil penalty. The DOJ was not involved.

Electronic Data Systems (2007)

- EDS is one of the worlds' largest service companies in the world; the company provides electronic data processing management and computer equipment. EDS' subsidiary paid \$720K to Indian government- owned companies between 2001 and 2003. The subsidiary had been struggling to perform its obligations with the Indian companies and the payments were made so the subsidiary would not lose contracts.
- EDS settled with the SEC and paid \$491K in disgorgement and prejudgment interest. The subsidiary's president also settled with the SEC and paid a \$70K penalty. The DOJ was not involved.

Textron Inc. (2007)

- Textron is a global, multi-industry company which does work in aircraft, defense and intelligence, industrial, and finance businesses. As part of an investigation into \$700K in kickback payments related to its sale of humanitarian goods to Iraq under the UN's oil for food program, Textron identified an illicit payment by an Indian subsidiary of approximately \$52K to a non-government customer to obtain business.
- As part of a settlement, Textron agreed to disgorge \$2.3M in profits, plus \$450K in pre-judgment interest, and to pay a civil penalty of \$800K. Textron was also ordered to comply with an FCPA compliance program. Textron was further ordered to pay a \$1.15M fine pursuant to a non-prosecution agreement with the DOJ.

Common Areas of Interaction with Indian Government Officials

- Public procurement/contracting with government agencies
- Customs clearance/importation of goods
- Immigration processes
- Real estate (purchasing and leasing land)
- Tax administration (excise and sales taxes, audits)
- Obtaining certificates, registrations, permits, and licenses (approval from multiple officials often required to obtain one permit/license)
- Gifts and entertainment (especially during religious festival, Diwali)
- Scheduling/passing inspections (fire, environmental, building)
- Government officials solicit donations for charitable/religious organizations
- Interactions with police/judiciary
- Third parties with ties to government departments/officials (consultants, agents, distributors, interns, and trainees)

India Corruption Risk Profile

Transparency International - Corruption Perceptions Index (CPI) 2011

- India ranked 95th out of 183 (tied with Albania, Swaziland and Tonga)
- Score of 3.1 out of 10 (0 = highly corrupt; 10=very clean)
 - Down from 87th in 2010
 - In comparison: New Zealand ranked 1st; Somalia and North Korea ranked 182nd
- TI Global Corruption Barometer 2010/2011
 - 74% of those surveyed in India believed that corruption in their country had worsened
 - Political parties, police, public officials, judiciary were all perceived to be affected by corruption
 - 44% believed that their government's actions to fight corruption were ineffective
- TI Bribe Payers Index
 - 84% of Indian companies believe bribes or facilitation payments are being paid to do business
 - 30% of Indian companies reported paying bribes to government officials to expedite government services
 - 54% of individuals surveyed reported paying a bribe to obtain government services

Inherent Risks When Interacting with India's Bureaucracy

Regulatory and Business Environment Challenges

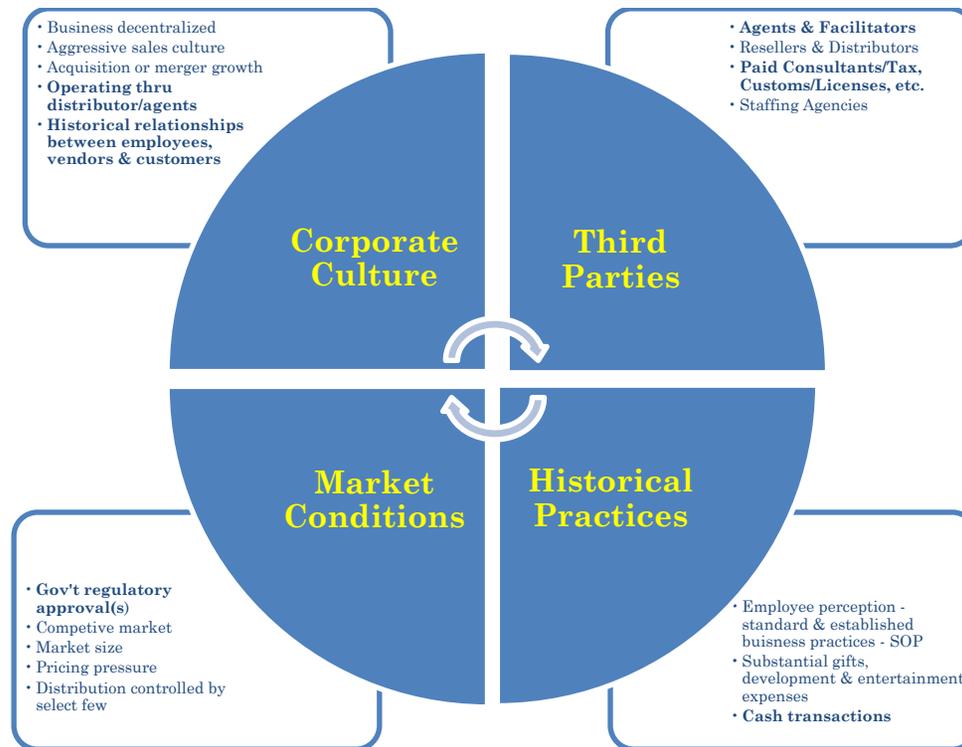
- Excessive bureaucracy and regulation
 - Procedures are complicated and not transparent
 - Several layers of approvals required to obtain licenses/permits
 - Practice of using "agents" to interface with government agencies
- Civil servants grossly underpaid
 - Accepted practice of "tips" or facilitation payments to civil servants for routine government services
 - Seen as an accepted method of augmenting meager salaries

- Prevention of Corruption Act
 - Prohibits public servants from accepting bribe
 - Prohibits giving of bribes to public servants
 - No exception for facilitation payments
 - Inconsistent enforcement

- Licenses and Permits
 - Licensing and permitting regulations are duplicated by national, state and local agencies
 - Many licenses and permits require several visits to government offices
 - Frequent requests for bribes from government employees to render routine government services
 - Refusal to pay will often result in prolonged application process
 - Many company employees do not distinguish between facilitation payments and payments made to impact outcome of inspection report
 - Government employees will often require that you make payment to a “trusted” third party who will, in turn, funnel the money to the government employee
 - Government liaison” services offered by certain vendors
 - Vendors will even provide a schedule of rates for amount of facilitation payments required by the various agencies
 - Environmental licenses
 - CEIG Licenses for electrical systems
 - Fire licenses
 - Explosive licenses

- Government Regulatory Inspections, Certificates, Consent and Activities that are Problematic
 - Electrical Safety inspections
 - Mechanical Equipment inspections
 - Labor Department inspections
 - Lift/Elevator Licenses and inspections
 - Pollution Control Board inspections
 - Fire Safety inspections
 - Police inspections – labor issues and workplace accidents
 - Health Department inspections
 - Diesel storage inspections
 - High Rise Building inspections
 - Sanitation Department plumbing inspections
 - Johnson Controls Confidential
 - Energy Meter Testing reports
 - Commercial use clearances
 - Air Consent (Operation & Establishment)
 - Occupation certificate from local authority
 - Annual Operations renewal
 - Structural certificate for floor load density
 - Water Consent
 - Hazardous Waste Handling and Disposal
 - Consent to Operate

Fraud & Corruption Factors – India



Indian Business Environment / Inherent Fraud Risk Challenges

Procurement related frauds

Overstatement of expenses / duplicate claims

Embezzlement of funds by employees

Collusion with vendors

Conflict of Interest

Vendor favoritism contract awards

Theft/piferaqe/diversion of products

Risk of corruption utilization of third party providers/agents/facilitators

Inflated sales revenue / Fictitious customer & sales orders

Hidden uncollectible receivables / unaccounted sales returns

Counterfeit Products

Bribery & inappropriate relationships with government officials and parties

What Companies and Organizations Should Do When Conducting Business in India

Whether forming a joint venture, acquiring a stake, merger, acquisition and/or entering into a business relationship in India; companies should undertake *anti-corruption due diligence* to determine if the entity(s) and/or individual(s) have been involved in bribery/corruption or other illegal activity. Other precautions include:

- Management & Supervisor Screening
- Risk Assessment (Identifying Key Risk Factors)
- Tailor Compliance Programs to Business Conditions in India (Policy & Procedure Reviews)
- Periodic Reviews (Interviews of Managers, Supervisors and Employees)
- Awareness (Training, handbooks & handouts)

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