Article

Due Diligence Fails

By By L Burke Files, CDDP, President, Financial Examinations & Evaluations, Inc (01/10/2013)

We have seen many of them; abject total monstrous failures of due diligence that make the headlines. War heroes running newspapers who never served in the armed forces, presidents of companies who do not possess the degrees claimed, accounting scandal after accounting scandal after accounting scandal.

Yet - there is a group of entities that with utter impunity conduct little or no due diligence, make massive errors and appear to be wholly unaccountable. A group of entities that seems to not only disown contradictory information but even tries to kill all messengers who offer contradictory or even updated information. A group that sets up its own internal study and research groups to find the root of the failure that is unlikely to find any member at fault. After several years a report of some weight is sent to a committee for recommendations that never meets.

Well if you have not guessed it by now, you have not been reading the newspapers. The group of entities who is the absolute worst at due diligence are governments. The very entities that require massive amounts of due diligence - lest we be fined with a ‘spank tax’ should we get it wrong - are in fact some of the most dysfunctional practitioners of the art.

It begins with a central problem - they write their own rules. Government bodies write the rules that they follow and they write the rules the public must follow - mind you each set of rules are different. Many of the rules are actually counter productive. Some rules or laws exacerbate the problem(s) addressed. I cannot tell you how many have been drafted in the last few years in the financial world, though I tried. I thought I would make a list of the counterproductive or wrongly headed rules, but it ran two sheets of legal paper and that was just the US! The EU list was three sheets of paper. I surrendered to the uncountable act of the unaccountable. The fighting part is the speed and diligence of their ignorance.

The ultimate acknowledgement that many of the rules are counterproductive is when those rules are too inconvenient for the government to follow. When this occurs, the government exempts themselves from the rules. In my book it is a tacit admission that they do not know or care about the impact of the rules or they fear the consequences of having to follow those rules.

In 1998, according to one web post, 84 members of the US Congress were arrested for drunk driving but cited congressional immunity and the charges were dropped. US Congress is also not subject to the Fair Labor Act, OSHA, or any one of a number of other compliance heavy rules.

My favourite is at the head of Taxastand in Europe. The very bureaucrats working to tax even the earnings we dream of are themselves exempt from income tax.

As rich as those two tid-bits are, my favourite are the Know Your Customer (KYC) laws. Not because they are silly - they are not silly - they are very necessary. They are my favourite in that so many of the leaders of governments have serious arrest records or convictions. Not to mention very long lists of red-faced moments in newspapers and television.

Just enter the search phrase ‘politicians with arrest records’ and you will see how many of them have records - and it is substantially greater than the background population.

Fully one fifth of US officials - between their arrest records and financial condition - would be unsuitable by any regulator in any jurisdiction to serve on the board of a bank - domestic or international.

Just look at the histories of a few politicians; Michael Misick of Turks and Caicos - two governors of the State of Illinois - George Ryan and Rod Blagojevich, the sex scandals of Dominique Strauss-Khan and Silvio Berlusconi… ahh the list is rich and long.

Governments also cause bubbles and panics. Afterwards they pass laws so it will never ever happen again! The government provides substantial temporary incentives through grants, mandates, and tax benefits causing a bubble in an industrial sector or the full economy. This was done to the solar industry in the United States and China by massive government tax incentives and grants and state supported loans. How many hundreds of millions of dollars evaporated in Soylindra? US$535 million. How many more loan guarantees are there in the solar industry? It is over three billion and counting. The last financial bubble burst 2007/08 and can be linked to several government mandates requiring affordable housing, incentivising the market to make loans they ought not to have made and then backing the companies that were buying the loans. A sector bubble is no different than a general bubble - it comes from false incentives and fiddling to pick winners and losers on the economy.

Chinese local leaders lie as a way to show how they met their targets and if this is not enough they bribe the central government officials and the SOE bank officers to give them more loans so they can build more buildings to keep up with the demand for the development of housing units. It is so bad in some places that towns of 200,000 have tens of thousands of apartments vacant - (officials over built), and some do not have proper running water, roads or sewage. Why, you ask? Well, the local managers were rated on the number of units built and they over developed – they did not sell the units built and have run out of money and credit to develop the infrastructure. Tianducheng, designed to look like Paris, which officially opened on the outskirts of Shanghai in 2007 is just such a town - at last report it has 2,000 residents, with units available for 100,000 plus - but no running water, sewage, or garbage pickup and the roads stop short of the city. The local council has 28 years of land they have purchased or seized under eminent domain to develop. They kept going as they had no market feedback mechanism at work.

So why is the government so utterly incompetent at due diligence or even the pronunciation of the phrase?

When there is a failure in government- and there are many - there is often no learning from the failure. For example, if an aircraft fails, there is an extensive analysis done on the cause of the failure. An exhaustive methodical study both subjective and objective is conducted to seek the truth. The cause, and thus the responsibility for the failure, is clearly identified, made public and shared to improve safety and reliability. Failures happen - but one must learn from failure and not repeat it. From my gimlet eyed view when failures occur in government they toss more money at the problem after the obligatory committee meetings, hearings, press conference and a sacrificial demotion or firing. Promotions within the government branch, after a failure in that branch, seem to be largely handed out to those who kept their mouths shut and supported the government.

In all of these cases there are a few common and glaring themes that should frighten us in the private sector, as governments around the world are making an historically unprecedented reach for more of our economic power.

Governments, their leaders and employees are not being held accountable

> Failure after failure occurs and the government does not have the proper feed back mechanisms. Failure is not something to learn from, but rather bury, bluster or blame. All people and institutions, public or private, have failures. All private firms have failures and these failures are used as learning experiences and to adjust behaviour. If they do not adjust, they fail.

There is rarely punishment for error or mistakes.

> Punishment - managerially or budgetary is a means by which punishment and corrective actions can be taken. Without having “skin in the game” - they are only concerned about their hides, which leads back to bury, bluster or blame.

Being insulated against punishment.

> Unions that are unchallengeable or too powerful, personal policies or laws that buffer any corrective procedures that may be taken, or just departments that are so powerful and aloof - are real impediments to a feed back mechanism to

change failing behavioural choices.

No incentive to change.

At this time I see no incentive to change toward better due diligence with proper feed back mechanisms for many of the governments. They are spending themselves into insolvency and are just raising taxes and buttoning up economies so they may further tax the economic life out of it. We will see more insolvent cities, counties, provinces, states and countries.

So where is the due diligence lesson?

Learn what not to do when you see others fail. If you see someone burn themselves touching a hot stove - I find that sufficient proof that I do not need to touch that stove to know it will injure me. Look at the failures described above - and do not repeat them or the process that allowed them to occur.

I have often been asked what do the best due diligence systems have in common? While a bit vague, as each system is very dependent upon each culture and company and industry, there is a common thread. The best due diligence systems provide an open and authentic exchange of information and even the smallest due diligence projects tend to be collaborative. All have an open system for communication as well as a 'silent tip line' for illegal, unethical, or any issue that would hurt or help the company. This back channel exists if a party is too afraid to speak up in public or through channels. This mode of communication is also open to all suppliers, vendors, the public and professionals that work with the firm.