



ÆGIS journal

Addressing threats that affect your bottom line

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Intellectual property being stolen or at risk? Call us!

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AEGIS journal, in conjunction with
The Center for the Study of Law, Science, and Technology,
Sandra Day O'Connor College of Law at Arizona State University
and
The OPSEC Professionals Society
will be hosting its two-day **Critical Information and IP Conference:**
Identification, Valuation, and Protection of Critical Information and Intellectual Property
For Directors, Finance Officers, and Counsel
At Arizona State University in Tempe, Arizona, **2-3 October 2007**
For information, contact us at conference@aegisjournal.com

1. Asset Location and Due Diligence — Information examination

Financial shenanigans are, well, financial in nature, and can be fairly subtle. Think back to Superman III, where a low paid junior programmer (Richard Pryor) has stolen money from a bank by transferring the fractional-penny rounding errors to himself. Robert Vaughn despairs of finding a thief that clever until Pryor screeches into the parking lot in his expensive race car. While we can find phantom employees by looking for employees who receive no health care benefits, we can't do this by listening to a narrative of how people are paid.

As financial investigators looking for concealed assets we often start by performing an audit on whatever records exist – and there are always records – trying to find where in the flow of funds money might have disappeared. It is a painstaking task, often akin to looking for a needle in a haystack. Records often produce not only answers, but questions that need to be asked, which in turn lead to answers.

If we are not lucky enough to have documents readily available in the hands of the client, we can develop a case without them by finding them elsewhere.

It is a more cumbersome – and more costly – process, but it can be done, particularly with the help of subpoenas.

We sometimes encounter unwillingness among smaller clients and their counsel to allow us to come and examine information they fortuitously have at hand. This is because they simply don't understand the process. They are on a limited budget compared to corporate clients, and don't want to spend the money that it costs to bring us in, have us put in the time examining the documents, and then send us back. They would rather we just phone in whatever questions we might have.

Unfortunately, even when we talk with a knowledgeable client, their answers to our questions are never as accurate and consistent as the financial records they are trying to describe, and may not spur us to ask the questions that need to be asked. This means that we often end up going out into the field to uncover a bit of intelligence, only to have the client tell us that they already knew that.

The bottom line is that finding concealed assets is a tricky business at best, and the best money-saving strategy involves the most appropriate use of all available information.

2. OPSEC, Economic Espionage, and Competitive Intelligence — What bankers can learn from public health

When we speak at conferences about protecting intellectual property and critical information – IPCI – there are two groups that we expect to have no interest in the subject. The first is people who work for PCAOB, who routinely tell us that since IPCI has no book value, there is no need to account for its loss, no matter what the SEC requires. While this will cause problems for corporations when shareholder lawsuits over improper disclosure of losses hit, even if they settle rather than going to court, we are not concerned here with them.

The second group is bankers who know that by the nature of their business they are simply not targets, and therefore do not need to take appropriate precautions to protect their IPCI. It is not as if they do not recognize that they have information that might be of potential value – such as their customer lists the sales records of their salespeople, or their marketing plans. The information contained in their customers' records might be another example: After all, wouldn't you like to know everyone to whom your competitor writes a check? It is merely that bankers **know** in their heart of hearts that nobody would go after such information.

This sort of denial is commonly seen in the world of dealing with public health issues. Sexually transmitted diseases, as an example, tend to spread because people believe that those with whom *they* are sleeping simply could not be infected. Public health statistics would beg to differ.

By the same token, the statistics on waste caused by unwillingness to deal with competitive intelligence, economic espionage, theft, and inappropriate disclosure are fairly compelling nationally: \$300 billion lost annually, with the cost per incident being \$50 million in manufacturing environments, and \$500,000 in non-manufacturing environments, including banks. This translates to 7,500,000 American jobs lost each year.

Is the banking sector large enough to be a target? Well there are thirty commercial banks listed in the Fortune 500, and their combined revenues rounds to \$635,472,000,000. Independent of our sure knowledge that banks are targets, the numbers should tell them that they must be very tempting targets indeed.

On the other hand, a strong case can be made that if your company takes a write-down of somewhere between \$3 and 25 billion because of enthusiasm for unsecured mortgages (a good investment if you manage the portfolio, and, as we have seen, a bad investment if you don't manage them), a \$100 million loss doesn't even hit the radar screen. So why would a senior manager care? Because while management might not care about \$300 billion, or 7,500,000 jobs, shareholders do, and when shareholders care the SEC tends to be concerned. In addition, when customer data is the end target, rather than the bank as holder of the data, customers who are injured tend to get cranky and litigious.

3. Executive Protection — Travel alternatives

Recently a friend had to take a business trip to Minneapolis, but couldn't get there because the weather had grounded all incoming flights. They ended up going the next day, and arrived barely on time. This has, of course, happened to all of us.

The worst case scenario is being in a foreign country and being unable to get out when something bad is happening. As an example, some time ago we were stuck in Teheran and, what with one thing and another, needed to leave quickly and unobtrusively, which precluded flying.

The next best choice was to take a train. We waited three days, which seemed like a very long time since at the time we were suffering from

cholera. Finally, we gave up on the train and took a bus across the border into Turkey.

The point of this (other than not to drink the water or eat fresh vegetables in certain countries) is that it is always important to have alternate travel options. In the case on not being able to fly to Minneapolis, another possibility might have been to fly to Chicago and take a train. Of course, if Chicago were also closed down that wouldn't have worked, and driving might have been the appropriate choice, depending on the level of urgency.

In the U.S., we are familiar with the alternatives. But what about when you travel abroad? What happens in the case of earthquake, or civil disorder? If you are high enough up the corporate food chain to have an executive protection team, they should have pre-planned for a variety of emergencies. If you are traveling on your own, you need to think of worst-case scenarios and make appropriate backup plans.

4. Technical Issues — On-shoring

It has been our experience that a wage difference of 50% or greater is a benchmark for moving jobs from the developed nations to the developing nations. As the wage difference disappears – a result of more companies competing for scarce human resources in the developing nations – those jobs return to the developed nations if the wage difference drops to only 25%. Because the cost of the programmers and engineers in some markets has risen to about 75% of those in the North America and Europe, some work outsourced to Bangalore, some design work sent to Italy, and some call centers in the Philippines and Costa Rica are coming back to the United States. In cases where there is value added – the cost difference is less of a factor. Independent of where they are located, groups that add positively to the bottom line are of value.

The jobs are most at risk for poorly run shops where work has been transferred as it was – our mess, your house – with no value added. Here, a cost savings of 25% is not enough do deal with several differences. Those include time, work quality, and, in embarrassingly few cases, the fear of loss of the IPCI.

It is important to note that the focus in off-shoring has been on the “process cost” that includes labor, materials, overhead, and regulation. None of this addresses the cost of origination. What did it cost to originate an idea or a product or a design? How, when you transplant the process to far-off lands

will you be able to keep the exclusivity of the origination? *In fine*, the cost of the loss of the IPCI has not generally been considered.

On a recent radio program, the interviewer was questioning the head of the American Chamber of Commerce in China. The question put was clear and to the point. “How much have the American operations in China been able to make?” The answer was equally clear and to the point. “Nothing – the locals copy designs and manufacturing technique, undercut the original owner, and remove the profit from the market.” If companies followed the SEC mandate to have internal controls in place to track these losses, it would also be interesting to see how that IPCI loss has affected the income statements and balance sheets to those who went to China.

In addition, other costs are frequently overlooked. For example, the opportunity cost of goods that take a month or more to be shipped can sometimes be significant. Another consideration is the future cost of on-shoring. We recently heard of a company that moved its IT support entirely to India. Some time after disposing of all their in-house knowledge workers, they were told by their contractor that not enough money was being made, and that their contract was being cancelled. It will be costly for them to build a new department here starting from scratch.

As wages rise abroad we can expect the same scenario in the manufacturing sector. We imagine that re-starting your manufacturing from the ground up, having given your existing plant to the Chinese, will be difficult and costly.

The conclusion one must come to is that a company’s senior managers must not only take into consideration the process of cost of manufacturing a product, but also a wide variety of other costs, not least of which is the cost of the loss of the origination and of the value of exclusivity. IPCI is at the core of the value of modern companies. It should be a consideration in making any decision.

5. Real Stories from the Field — Bribery

The 1977 Foreign Corrupt Practices Act (FCPA) bans any company, domestic or foreign, that does business in the U.S. from bribing government officials anywhere in the world.

A number of U.S. and E.U. companies are getting in trouble for bribing officials of other governments or potential customers. The recent disclosure of BAE Systems overcharging for Tornado aircraft and diverting the surplus to other accounts has brought this to the forefront.

It seems that, at the request of the Saudi government and with the approval of the British government, these payments were structured so that funds could leave Saudi Arabia and be used as part of their funding of activities around the world, such as arms for Contras or defending Afghanistan from the Russians. However, it does not matter if BAE Systems had government approval or not. The U.S. Justice Department has been probing a number of European companies such as BAE Systems, Siemens, and Total, as well as others who may have bribed officials to get contracts. While they may not be fined as the oil services companies Vetco Gray and Baker Hughes have been, they do have American Depositor Receipts trading on U.S. exchanges, and they could be de-listed and banned from U.S. capital markets.

Similar problems have been coming to light for those U.S. companies that have been on an acquisition binge overseas in countries like China and Indonesia where “incentives” are the norm. Industries most likely to be in trouble are those that require government licenses or approvals. Natural resources, telecommunications, pharmaceuticals, and resorts spring to mind. Acquisitions have been made by successful companies and/or well positioned companies that have achieved success in part as a result of their willingness to take care of those who take care of them.

In acquisition one not only needs to take stock of the success and the advantageous positioning of a company but also the provenance of that success. It’s a damnable position to be in, either as an acquiring entity or as one who already owns an entity, to discover how the success and position was achieved. If those who “incentivized” others don’t disclose these matters voluntarily, and if you choose not to demand and look for appropriate behavior, you can expect that people will yield to temptation under the pressure to perform.

How can you tell if illegal activities are going on? By looking! Indicators can be subtle, but look for poorly documented (or undocumented) expenses and similar types of transactions with unknown companies where there is no likely economic reality. “Consultant” fees need to actually show work for those fees, and finder fees need to be traced very closely.

6. Book and Product Reviews

In a rare move, we are today discussing two books, *Better* and *Reinventing the CFO*, each of which falls into our must-read category. Past must-read books were:

- *Inside the Tornado* by Geoffrey A. Moore
(<http://www.lubrinco.com/ejournal/ej200211.pdf>)
- *Beyond Fear* by Bruce Schneier
(<http://www.lubrinco.com/ejournal/ej200309.pdf>)
- *Taking Sex Differences Seriously* by Steven E. Rhoads
(<http://www.lubrinco.com/ejournal/ej200411.pdf>)
- *All You Need Is Love, and Other Lies about Marriage* by John W. Jacobs, M.D. (<http://www.lubrinco.com/ejournal/ej200504.pdf>)
- *With Winning in Mind* by Lanny Bassham
(<http://www.lubrinco.com/ejournal/ej200509.pdf>)

In spirit and approach, both *Better* and *Reinventing the CFO* deal with the same subject: Doing things that increase customer value, and cutting out things that don't.

Better: A Surgeon's Notes on Performance

Atul Gawande

Metropolitan Books (Henry Holt) ISBN: 0-8050-8211-5 288 pages \$24.00
<http://www.henryholt.com/metropolitanbooks.htm> 1-646-307-5095

There are a number of areas in which we would ideally like everyone with whom we deal to be better than average, and where we hold them to a higher standard than we would in other areas. Medicine is one of these.

Why should you read a book about how doctors can be better? Besides the fact that it is well written and tells a fascinating story, you should read it because much of what Gawande discusses in this book is globally applicable, and the implications for business are clear.

We would like *our* medical care, and that of our loved ones, to be the best possible. If it isn't, and particularly if this causes harm (An average of 195,000 people in the USA died due to potentially preventable in-hospital medical errors in each of the years 2000, 2001 and 2002, according to a study of 37 million patient records by HealthGrades.), we would like the practitioner to be punished, or removed from the medical gene pool.

This is a tricky area, because many procedures involve significant risk. As an example, this editor's 90 years old father underwent a high-risk cervical laminectomy and died from a non-foreseeable spinal embolism the day before he was to be released. There was no thought of recourse because there was no fault. The sister of a friend had the same surgery, which was of lower risk because of her age (she was in her 40s) and good health, but died subsequently because of the aftercare. While in this case there was fault, her family took no action because of intimidation and threats of retribution from the hospital, but that is a different issue.

In less obvious cases than these, the balance of blame can be hard to place as emotions run high, but medical associations have estimated that up to five percent of medical malpractice suits are baseless. Simple arithmetic tells us that they are saying that ninety-five percent have merit.

In this book Dr. Gawande approaches the question of what, as a doctor and a surgeon, makes one better than average. He considers three factors:

- Diligence
- Doing right
- Ingenuity

Dr. Gawandy is a great proponent of both transparency and measurement. With these you can see how well doctors, hospitals, and specialized medical treatment groups are doing. You can then try to figure out why some groups, ostensibly doing the same things, are more successful than others. You may initially be measuring the wrong thing, but as long as you keep going you will be able to eliminate the meaningless measures and find those that help you become better.

The down side to this, of course, is the same as is faced any time you measure performance: While those who do well are rewarded, those who are below average or bad are penalized. Those who are penalized don't like this, and will insist that what is being measured is not what should be measured.

This holds true in all arenas, of course. As an example (taken from *Reinventing the CFO*), "The ratio of average CEO compensation to the pay of the average worker in the United States went from 41:1 to 411:1 between 1980 and 2001." Some justify this by saying that it is hard to run a large corporation, and few people who can do it, so that any amount paid is worth it. And yet, "In 2002 CEO annual compensation (salary plus bonus) rose by 10 percent, while total return as measured by the S&P 500 fell by 24 percent." The book further quotes research which says, "Of the 1,435

companies that have appeared in the Fortune 500 from 1965 to 1995, he found that only eleven executives had transformed their companies from “good” to great.” In effect, we would be better off if these high paying jobs were outsourced to India or China, where an equally good CEO could probably be made available for \$500 thousand a year, not \$500 million!

Reinventing the CFO: How financial managers can transform their roles and add greater value

Jeremy Hope

Harvard Business School Press ISBN: 1-59139-94509 272 pages \$29.95
<http://harvardbusinessonline.hbsp.harvard.edu/> 1- 617-783-7500

In many companies the CFO is little more than a fancy accountant, whose job is to manage the budgets and assure regulatory compliance. While this might have been appropriate in a brick-and-mortar world, Hope believes that the role is no longer appropriate in a world where seventy percent of a company’s assets are in its intellectual property, and where markets change long before a budget is finalized.

In Hope’s view, the function of the modern CFO is to be part of the management team and help guide financial decisions by being a financial risk manager, and to increase customer value, rather than merely being a cost center. The CFO is now supposed to make money for the corporation, not merely count it.

Hope starts by advocating decentralization of power, eliminating annual budgets in favor of rolling estimates that are actually helpful, and eliminating useless procedures. He notes that “Companies report an average of 132 metrics to senior management every month (83 financial and 49 operational). This is more than six times the number recommended by Kaplan and Norton for a balanced scorecard.” Unfortunately, “most measures focus on what can be easily measured (functions or activities) rather than what *should* be measured (customer value).” Anyone who works in finance knows these things to be true, and that cutting down useless metrics will bring the workload of finance staff down to something approaching rational.

One problem noted by Hope was that much risk management addresses the letter, rather than the spirit of the law. This is something that we have seen in our role as developers of AML policy. Management generally doesn’t really care about money laundering: What they care about is compliance. As Hope accurately puts it, “the primary problems are not with documentation and

audit trail. They have to do with the causes of excessive risk taking, malpractice, and greed.”

There is some lip service given to the value of cutting waste. Hope states that “one of the greatest services a CFO can perform for the organization is to wage a war on waste.” One CFO discusses dumping a thousand employees and moving operations abroad, which saved the company \$100 million. While \$100 million (and 1000 jobs) might seem like a lot of money (and jobs), it is roughly twice the remuneration of the top six senior managers. We would therefore guess that much of what is done in this area is more financial theatre than economic necessity.

Similarly, Hope discusses the importance of intellectual property. IPCI, however, is still little understood by senior managers, and its loss still accounts for too little to be of real interest. While loss of IPCI may cost the country \$300 billion in a year and 7,500 jobs, that is a small portion of the U.S. GDP and employment, so it doesn’t really hit the radar screen, either. As one senior manager put it when discussing his firm’s level of concern over loss of IPCI, “So I lose \$100 million and have to close a division. I’m a \$35 billion company. Why would I care?”

As with Gawande, Hope is a big believer in transparency, which allows people to compare themselves not with budgets set either low enough to be meaningless or high enough to ensure fraud, but with the performance of their peers.

To a large extent we would say that Gawande’s belief in diligence, doing right, and ingenuity are closely aligned with Hope’s belief in diligence, doing right, and ingenuity. We, who are not CFOs and run small companies, found practical value in *Reinventing the CFO*, as we did in *Better*. For those of you in positions of responsibility in larger organization, the value should be even greater in real terms.

Both *Better* and *Reinventing the CFO* are must-read books, and we hope you will make time to actually read both of them.

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- **Identification, valuation, and protection of intellectual assets and critical information.**
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