Good Corporate Governance: Essential to Prevent Conflicts of Interest and Fraud
Pakistan’s Experience

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Presentation Outline

- Pakistan & Corporate Sector
- Conflict of Interest & Fraud
- Why Conflict of interest is so harmful to the organizations & economy
- Cost of Fraud to the economy & organizations
- Fraud Triangle
- Corporate Governance (focusing on anti fraud) framework in Pakistan
  - Ethics / Conflict of interest related provisions in the Companies Law
  - Code of Corporate Governance for listed Companies / conflict of interest related provisions
  - Transparency, Disclosure and Financial Reporting
  - Compliance mechanisms
- What more needs to be done / way forward for fraud (conflict of interest) prevention
About Pakistan

- Second largest country in South Asia/Subcontinent.
- Population: 165 Million
- GDP US $ 155 Billion
- Per Capita Income US $ 935
- GDP growth: 7%, in last five years, one of the highest growth after China & India in recent years.
Pakistan’s Corporate Sector & Market Profile

- Three stock exchanges, KSE being the largest and main market.
- KSE – consistently one of the best performing market during last five years.
- 650 listed companies
- Second largest Market / Economy in South Asia
- Market cap of US $ 75 billion, 50% of the GDP
- Over 50,000 public (non-listed) and private companies
Conflict of Interest

- A conflict of interest occurs when a person or organization acts on behalf of another individual or organization; and has, or appears to have, a hidden bias or self-interest in the activity undertaken; and the hidden bias or self-interest is actually or potentially adverse to the interests of the individual or organization being represented; and the hidden bias or self-interest is not made known to the individual or organization being represented.

- When a person's conflict of interest results in economic or financial loss to the individual or organization on whose behalf the person is acting, then fraud has occurred. Conflict of interest can exist on its own, or can be an intricate part of other frauds such as bribery and illegal gratuities.
Conflict of Interest

- Actions resulting from Conflict of interest, generally constitute most costly frauds, since these happen at senior management / governance level.

- One of the objectives of Corporate Governance is to prevent fraud through enhancing transparency, integrity and accountability.
Fraud Defined

- The term “Fraud” generally not defined in most jurisdictions.
- Although not specifically defined in criminal law, but every body seems to know what it is (except those who commit it, and purport to have no idea what they had done was wrong!).
Fraud Definition

- It is like an elephant, Easier to recognize than to define.
- An intentional act done by one or more individual among management, those charged with governance, employees or third parties involving the use of deception to obtain an unjust or illegal advantage. *(ISA 240 –)*
Classification of Fraud

Corruption

Asset Misappropriation

Fraudulent Financial statements
Measuring Cost of Fraud

- Determining the true cost of fraud & abuse is an impossible task, because fraud is a crime based on concealment.
- Some Frauds are never detected, or only caught after they have gone on for several years.
- Many frauds that are detected are never reported for variety of reasons, including reputation issue. And those that are reported, are often not prosecuted.
- Finally, there is no agency or organization specifically charged with gathering comprehensive fraud related information.
- All of the above factors combine to make an estimate of the total cost just that: an estimate.
2004 survey by Association of Certified Fraud Examiners of US on occupational fraud:

- On an average, US organizations lose 6% of their revenue.
- Estimated Loss US $ 660 billion a year – about $4,500 for every worker.
- 59% of frauds occur due to weaknesses in internal controls.
- 95% of US companies reported employee theft.
Cost of Fraud?

- It's much less expensive to prevent an embezzlement than it is to investigate one.
- According to one study, it is estimated that for each $1 lost due to any Fraud, the orgs lose an additional $4.
- These calculations are conservative, and don't take into account other losses the org will ultimately suffer, including reputation loss.
What Does Fraud Really Cost?

- To put it another way, each loss caused by internal or external fraud costs at least five times the original amount:
  
  * One dollar in actual cash or property value is lost;
  * A second dollar is spent identifying how the crime was committed;
  * A third dollar is spent in identifying who committed the crime;
  * A fourth dollar is spent prosecuting the person who committed the crime; and
  * A fifth dollar is spent in suing the person who committed the crime for the recovery of the money taken.
Why Fraud is a Costly Business

**Problem**

- Fraud Losses Reduce Net Income $ for $
- If Profit Margin is 10%, Revenues Must Increase by 10 times Losses to Recover Affect on Net Income
  - Losses…… $6 Million
  - Revenue…. $60 Million

**Fraud Robs Income**

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To restore income to $10, need $60 more dollars of revenue to generate $6 more dollar of income.
2004 survey by ACFE

- Occupational fraud and abuse is widespread problem that affects practically every org, regardless of size, location & industry.

- Most common fraud (over 90%) involves asset misappropriation. Examples are theft or misuse of assets such as stealing of inventory, cash, payroll fraud, skimming of revenues etc. The asset that is most frequently targeted is Cash.

- Corruption, in which fraudsters wrongfully use their influence in a business transaction in order to procure some benefit for themselves or another person, contrary to their duty to employer or the rights of another. (common example include kickbacks, engaging in conflicts of interest.)

- Fraudulent fin. Statements, were least commonly reported but are the costliest. As against the median loss of $ 93k for asset misappropriation, median loss for fin. Statement fraud was over $ 1 million.
2004 ACFE Survey / Report to the nation

- Losses caused by men are nearly four times those caused by women.
- Losses caused by managers are four times those caused by employees.
- Losses caused by executives & owners are 16 times those of their employees.
- While the occurrence of employee fraud was most frequent, the cost of fraudulent financial reporting was much higher.
- Small businesses are the most vulnerable to fraud and abuse
Financial Statement Fraud

- Financial statement fraud causes a decrease in market value of stock of approximately 500 to 1,000 times the amount of the fraud.

$7 million fraud $2 billion drop in stock value
Fraud- statistics

2004 ACFE Survey / Report to the nation

Fraud Detection

- The most common method for detecting fraud:
  - By a tip from an employee, customer, vendor or anonymous source.
  - Among the cases that were detected by a tip, 60% came from employees, 20% from customers, 16% from vendors, and 13% from anonymous sources.

- Orgs with fraud hotlines & anonymous reporting cut their fraud losses by approx. 50%.

- Among frauds committed by owners & executives, which tend to be most costly, over half of all cases were identified by a tip.

- Int. controls, int. & ext. audits, notifications by employees, background checks are the leading ways on uncovering frauds with int. controls being the fastest growing method.
Who Detects Frauds?

Initial Detection of Occupational Frauds\textsuperscript{10}

- **Tip**
  - 2004: 43.0%
  - 2002: 39.6%
- **Internal Audit**
  - 2004: 23.8%
  - 2002: 18.6%
- **By Accident**
  - 2004: 21.3%
  - 2002: 18.8%
- **Internal Controls**
  - 2004: 18.4%
  - 2002: 15.4%
- **External Audit**
  - 2004: 10.9%
  - 2002: 11.5%
- **Notified by Police**
  - 2004: 0.9%
  - 2002: 1.7%
Fraud Triangle

Heat

Oxygen  Fuel
Fraud Prevention at Macro Level.

- Reduce Supply of motivated offenders.
- Educate the public/target.
- Reduce the opportunities.
The Fraud Triangle – 3 conditions

- **Perceived Opportunity:**
  Circumstances exist
  - e.g. absence of controls, ineffective controls, or the ability of management to override controls

- **Incentive/Pressure:**
  Management or other employees may have an incentive or be under pressure, which provides a motivation to commit fraud.

- **Rationalization/Attitude:**
  Those involved in a fraud are able to rationalize a fraudulent act as being consistent with their personal code of ethics. Some individuals possess an attitude, character, or ethical values allowing them to knowingly and intentionally commit a dishonest act.
Some Common Myths about Fraud

- It doesn’t exist in our organization.
- If it does, it is not significant.
- Most fraud goes undetected.
- Fraud prevention/ detection is the responsibility of the auditors.
Common Myths

- **Trustworthy staff.**
- **Controls will prevent all fraud.**
- **Audits will detect all frauds.**
Actually

- **IT IS THE TRUSTED EMPLOYEES WHO COMMIT FRAUD**
  when they are given:
  - **Responsibility:**
  - **Authority:** and
  - **Independence without adequate monitoring.**
Regulation & Corporate Governance in Pakistan

- Regulatory Framework
- Regulators include
  - Securities & Exchange Commission of Pakistan—regulates all corporate entities and administers corporate laws.
  - State Bank of Pakistan regulates banking sector
  - The Institute of Chartered Accountants of Pakistan, regulator of Accounting Profession
Provisions to prevent Conflict of interest in the Statute

- Provisions in the Companies Ordinance re conflict of interest & promote transparency include:
  - Loans to directors (S-195)
  - CEO not to engage in competing business (S-203)
  - Investment in (including loans to) Associated Companies (S-208)
  - Disclosure of interest by directors (S-214)
  - Interest of other Officers (S-215)
  - Interested directors not to vote (S-216)
  - Declaring a director to be lacking fiduciary behavior (S-217)
Provisions to prevent Conflict of interest in the Statute

- Disclosure to members of director’s interest in contracts appointing CEO, Secretary etc. (S-218)
- Register of contracts, arrangements and appointments in which directors are interested (S219)
- Register of directors shareholding (S220)
- Disclosure by directors of their shareholding (S-221)
- Submission of statements of beneficial ownership (S-222)
- Prohibition on short selling (S223)
- Trading by directors, CEO, officers & principal shareholders (S-224)
- Employee’s Provident Fund (S-227)
Accounts & Disclosure

- All companies required to maintain proper books of account (S-230)
- Final Statements prepared in line with applicable IFRS, and mandatory requirements of the Ordinance. (233, 234).
- Accounting Framework- All IFRSs except IFRS-1, IFRS 4.
- On the whole, the accounting & reporting framework considered in line with International Best Practices.
- ICAP has adopted all International Standards on Auditing to enable audit in line with int. best practices.
- Enforcement of IFRSs and disclosure requirements by listed companies & Banks considered effective:
  - Effective monitoring by SECP (nearly 25 companies auditors penalized & 100s of enforcement actions)
  - Effective disciplinary process (severe penalties, including removal from membership imposed)
SECP Code

- Drafted by ICAP’s Committee.
- Enforced by SECP through listing rules.
- Applicable to listed entities & all banks & DFIs.
- Key requirements include:
  - Composition- at least 25% non-executive directors and at least one independent director
  - Director not to serve on boards of more than ten listed companies, must be a tax payer, and should not be a defaulter of loans.
  - Responsibilities of chairman & CEO to be defined.
  - Boards to approve mission, vision, strategy, statement of ethics and major policies. (statement of ethics required to be signed annually by all board members & employees.
  - Boards required to exercise certain powers, approve key policy framework and issue certain statements.
  - Certification of fin. Stats. By CFO & CEO before their approval by the audit committee & the board.
Board to establish sound system of internal control and issue a statement on the same.

Statement of Ethics- annual communication & confirmation

Significant issues/matters to be placed for decision of the Board.

Audit committee – composition, TOR, Meetings.

Requirement to set up an internal audit function.

External auditors. (Rotation, restriction on non-audit services, quality control, compliance with IFAC ethical guidance etc.)

Appointment of CFO, Company Secretary & head of internal audit and their terms to be approved by the Board.

CFO & Company Secretary : removal only with the approval of the board.

CFO & Company secretary to attend board meetings.

Board must ensure true & fairness of financial statements, and give certain statements (going concern, related parties
Key issues in Pakistan

- **Related party loans**
  - Section 208 – related party financing / loans
    - Monitoring & enforcement by SECP has significantly controlled this matter.

- **Financial Reporting**
  - Reasonable success achieved as far as listed companies financial reporting and disclosure is concerned.
  - SECP’s monitoring of the financial reporting & ICAP’s quality assurance review, oversight of the audit and disciplinary process has resulted improved compliance.

- **Conflict of interest related frauds in the Corporate Sector**
  (such as awarding contracts to favorites, kick backs, double booking keeping, relating party transactions not at arm’s length etc.) are still pervasive.
Many stakeholders commended regulators’ role during recent years for improving the quality of financial reporting. A majority of the interviewed stakeholders praised the initiatives undertaken by the SECP, SBP and ICAP geared toward improving the quality of financial reporting in Pakistan. Stakeholders viewed that mandatory application of IFRS, monitoring and enforcement of standards and introduction of QCR were important steps toward establishing a sound corporate financial reporting regime.
Way forward

- **Fraud Reporting Procedures**
  - Establish hot lines
  - Appoint an Official Responsible to receive / attend to all complaints, for which proper log should be maintained.
  - Protection / encourage whistle blowing / anonymous complaints

- **Anti-Fraud Programs and Controls should be established**
  - Creating a culture of honesty and high ethics
  - Evaluating Anti-Fraud Processes and Controls
  - Developing an appropriate oversight process

- **Survey & Research is required in the emerging markets to see the impact of Fraud on the Economy.**
Creating a culture of honesty and high ethics

- Setting tone at the top
- Creating a Positive Workplace Environment
- Hiring and Promoting (HR)
- Training (on ethical values/fraud reporting)
- Confirmation (on code/core values)
- Discipline (all wrong doing is severely punished)
- Zero Tolerance for wrong doing
Directors and officers set the “tone at the top” for ethical behavior within any organization.

Research in moral development strongly suggests that honesty can best be reinforced when a proper example is set—sometimes referred to as the tone at the top.

The management of an entity cannot act one way and expect others in the entity to behave differently.

Management must show employees through its words and actions that dishonest or unethical behavior will not be tolerated.
Creating a Positive Workplace Environment

- Wrongdoing occurs less frequently when employees have positive feelings about an entity than when they feel abused, threatened, or ignored.

- Factors that increase the risk of fraud include:
  - Top management does not seem to care or reward appropriate behavior.
  - Negative feedback / lack of recognition for job performance
  - Perceived inequities in the organization
  - Autocratic rather than participative management
  - Low organizational loyalty or feelings of ownership
  - Unreasonable budget expectations or other financial targets
  - Less-than-competitive compensation / low salaries.
  - Poor training and promotion opportunities
  - Poor communication practices or methods.
Evaluating Anti-Fraud Processes and Controls

- Identifying & Measuring Fraud Risks
- Mitigating Fraud Risks
- Implementing and Monitoring Appropriate Internal Controls
What Are Antifraud Programs and Controls?

- Identify fraud risk factors, fraud risks and fraud schemes
- Monitor effectiveness of antifraud programs and controls (including management’s testing & evaluation under 404)
- Communicate information to support antifraud programs and controls throughout the entity
- Set proper tone at the top
- Establish code of conduct/ethics
- Controls gap analysis
- Link fraud risks to mitigating control activities
Way forward

- Finally, a fraud awareness campaign is required among public to fight fraud-

- **Be Alert, Fraud Exists : Do not be victim !**
Thank you