Chapter 4
Conflict of interest—the soft side of corruption

The intersection of the public and private sectors creates opportunities for bribery—but corruption does not always manifest itself as a financial crime. Conflicts of interest occur when private interests compromise official, public, or organizational interests. This workshop defined conflict of interest, and presented emerging issues in identifying and managing real and potential conflicts. The session addressed country-specific approaches to managing conflicts of interest, and showed that the relationship between conflict of interest and corruption is highly subjective issue. The perspectives of the private sector, and the legal and auditing professions were presented.

The session opened with a discussion on what conflict of interest is, how the definition and practical implications have evolved, and why it matters in today's context. Rules, laws, and policies are not enough: understanding the issues and ensuring capacity to implement the rules, laws, and policies are equally—if not more—important. In many cases, conflict of interest standards exist or are included within specific legislation, but they are not enforceable.

The session also discussed the situation in Indonesia, where conflict of interest is not specifically defined (except in the capital market law) and is not well understood. The UNCAC now provides Indonesia with an opportunity to revisit the issue.

The conflict of interest inherent in independent audit services and how conflict of interest can manifest in a sector context were also examined. In both cases, it was agreed that conflict of interest is natural. While conflict of interest cannot be avoided, it can be managed.

OECD Guidelines, Toolkit, and Emerging Concerns

János Bertok
Principal Administrator, Innovation and Integrity Division, Public Governance and Territorial Development Directorate

Conflict of interest: a major concern

Conflict of interest in both the public and private sectors has become a major matter of public concern worldwide. There is a growing expectation from an increasingly informed and educated citizenry that governments will ensure that public officials perform their duties in a fair and unbiased way, so that decisions are not improperly affected by self-interest or considerations of personal gain. The public sector is increasingly commercialized and works in increasingly close relationship with the business and nonprofit sectors, giving rise to the potential for new forms of conflict between the individual private interests and public duties of public officials.

Corruption and conflicts of interest are related phenomena; they are "two sides of the same coin." Corruption can arise from a conflict of interest which has been inadequately identified or managed. In a rapidly changing public sector environment, conflicts of interest will always be an issue for concern. A too-strict approach to controlling the exercise of private interests may be conflict with other rights, or be unworkable or counterproductive in practice, or may deter some people from seeking public office altogether. Therefore, a modern conflict of interest policy seeks to strike a balance by identifying risks to the integrity of public organizations and public officials, prohibiting unacceptable forms of conflict, managing conflict situations appropriately, making public organizations and individual officials aware of the incidence of such conflicts, and ensuring effective procedures are deployed for the identification, disclosure, management, and promotion of the appropriate resolution of conflict of interest situations.

OECD Guidelines and Toolkit for Managing Conflict of Interest

The OECD Guidelines for Managing Conflict of Interest in the Public Service responded to a growing demand to ensure integrity and transparency, and reduce bias and abuse of office in the public sector. The OECD Guidelines help government institutions develop and implement an effective conflict-of-interest policy that fosters public confidence in the integrity of public officials and official decision making. The Guidelines provide a practical framework of reference for reviewing existing policy solutions and for modernizing mechanisms used to manage conflict-of-interest situations in line with identified good practices. The Guidelines, which were approved as an OECD Recommendation in 2003, provide a comprehensive benchmark for countries, against which it will be possible to compare, assess, and evaluate policy effectiveness.

The Guidelines developed a simple and practical definition of "conflict of interest" to assist effective identification and management of such conflicting situations, namely, "a conflict between the public duty and private interests of a public official, in which the public official has private-capacity interests which could improperly influence the performance of their official duties and responsibilities."

The Guidelines present set of core principles with standards and procedures for identifying and resolving conflicts (Part 1. Developing the Policy Framework) and management measures for putting the Policy Framework into practice (Part 2. Implementing the Policy Framework). Key elements of successful implementation include a clear and objective definition of conflict of interest, demonstrated leadership commitment, practical management systems, coordination of preventive measures, such as reviewing "at-risk" areas for potential conflicts, and positive enforcement (e.g., control, monitoring, and management strategies) to promote a public service culture where conflicts of interest are properly identified and resolved or managed without unduly inhibiting the effectiveness and efficiency of public organizations.

The Guidelines also support partnership with employees and recommend "a new partnership with the business and non-profit sectors" (in the form of awareness-raising, citizen involvement, and proactive safeguards against potential conflicts, etc.) in accordance with clear public standards defining the parties' responsibilities for integrity.

Identifying a specific conflict of interest in practice can be difficult. Resolving the conflicting interests appropriately in a particular case is something that most people find even more challenging. To provide hands-on support, the

OECD Toolkit for Managing Conflict of Interest in the Public Sector presents specific techniques, resources, and strategies for identifying, managing, and preventing conflict-of-interest situations more effectively; and increasing integrity in official decision making, which might be compromised by a conflict of interest. This Toolkit provides nontechnical, practical help to enable officials recognize problematic situations and help them ensure that integrity and reputation are not compromised. The tools themselves are provided in generic form. They are based on examples of sound conflict-of-interest policy and practice drawn from various OECD member and nonmember countries. They have been designed for adaptation to suit countries with different legal and administrative systems.

The OECD reviewed progress made by member countries in implementing the Recommendation and reported on trends in recent developments for modernizing conflict-of-interest policy and practice as well as the impact of the Guidelines. The review process also identified emerging concerns, namely, post-public employment and lobbying.

Post-public employment

There is increased concern about movement. Increased mobility of personnel between the public and the private sectors has supported labor-market dynamism. When officials leave public office—either permanently or temporarily—to work for private or nonprofit sectors, however, concerns of impropriety (such as the misuse of "insider information" and position) can put trust in the public service at risk. Consequently, many countries are making it a priority to review and modernize arrangements to effectively prevent and manage conflict of interest in post-public employment. Most post-public employment offenses occur when public officials use information or contacts acquired while in government to benefit themselves, or others, after they leave government. However, despite the use of the term "post-public employment," these offenses can also occur before officials actually leave government. Major post-public employment problem areas involve public officials when they

- seek future employment outside the public service;
- conduct post-public employment lobbying back to government institutions;
- switch sides in the same process;
- use "insider information" such as commercially sensitive information; and
- are reemployed in the public service, for example, to do the same tasks.

The challenge for governments is to strike an appropriate balance between fostering public integrity through adequate post-public employment instruments and preserving a reasonable measure of employment freedom to attract experienced and skillful candidates for public office. Survey findings show that the vast majority of OECD countries have established basic post-employment standards to avoid conflicts of interest. Several countries have even strengthened restrictions in the past years. However, only a few countries have tailored standards to risk areas, for example, when regulators or procurement officials move to the private sector. In addition, enforcing established standards and imposing suitable sanctions remain a challenge for many countries. Ensuring compliance with post-public employment measures can indeed be particularly difficult because most post-public employment offenses are committed by public officials who, by leaving the public sector, move somewhat beyond administrative government control.

To help policy makers, the OECD developed Principles for Managing Post-Public Employment Conflict of Interest that provide a point of reference for reviewing and modernizing post-public employment policy and practice. The Principles were designed to support efforts to prevent actual or potential conflict of interest in public office, such as by requiring that "public officials should not enhance their future private sector employment prospects by giving preferential treatment to potential employers" in decision making. In reviewing their actual arrangements, policy makers may consider systematically examining the extent to which existing regulations, policies, and practices can meet the requirements of the principles as a first step.

Moreover, the Post-Public Employment Good Practice Framework provides options for implementation of the Principles. The Framework addresses strategic aspects of managing a post-public employment system and provides a structure for developing coherent and comprehensive post-public employment policy and practice. Selected elements of good practices are also presented in the Framework to give concrete examples of options that could be considered benchmarks. Key pillars of the Post-Public Employment Good Practice Framework include:

- The post-public employment system contains the instrument(s) needed to deal effectively with its current and anticipated post-public employment problems and emerging concerns.
- The post-public employment instrument(s) is linked, where feasible, with instrument(s) dealing with conflict of interest in the public sector and with the overall values and integrity framework.

- The post-public employment system covers all entities for which post-public employment is a real or potential problem and meets the distinctive needs of each entity.
- The post-public employment system covers all important risk areas for post-public employment conflict of interest.
- The restrictions—particularly the length of time limits imposed on the activities of former public officials—are proportionate to the gravity of the post-public employment conflict of interest threat that the officials pose.
- The restrictions and prohibitions contained in the post-public employment system are effectively communicated to all affected parties.
- The authorities, procedures, and criteria for making approval-decisions in individual post-public employment cases and for appeals against these decisions are transparent and effective.
- The enforcement sanctions for post-public employment offenses are clear and proportional, and are timely, consistently, and equitably applied.
- The effectiveness of the policies and practices contained in each post-public employment system is assessed regularly and, where appropriate, is updated and adjusted to emerging concerns.

Dealing with post-public employment problems has been a relatively recent challenge in many countries. However, even countries with established post-public employment frameworks have faced newly emerging concerns—driven by constantly evolving sociopolitical contexts—that have forced governments to adjust existing regulations, policies, and practices. The OECD report draws attention to reviewed elements of good practices—identified at the subnational and national levels—to help decision makers by outlining alternative options as valuable benchmarks and sharing experiences and lessons learned.

Conflict of Interest in Indonesia: Business as Usual

Arief T. Surowidjojo
Founding partner of Law Firm Lubis Ganie Surowidjojo; Former chairperson of the Supervisory Board of Transparency International — Indonesia

Conflict of interest: a major concern

Indonesia does not have a specific law on CoI. Rather, the concept is used in various laws and regulations, without one all-purpose definition. Conflict of interest is defined in the Law on Depository Insurance Agency and in the Law on Capital Markets, for the respective purposes of these acts. However, the definitions used in those acts are not sufficient in discussing issues of CoI in the context of governance, clean government, and wider anti-corruption efforts.

If a more precise definition of CoI is included in the law, it is more likely that law enforcers will enforce it. But while definition is compromised, or could give rise to different interpretations, a loophole is opened; and regardless of how narrow the loophole is, the concept of CoI is rendered ineffective and useless in a corrupt environment.

It has to be said that conflict of interest is notoriously difficult to define; this can be observed in the drafting of CoI laws in other jurisdictions. The conflict of interest law in force in the Czech Republic from 1992 to 2006 confuses conflict of interest with actual corrupt conduct, as follows:

"A conflict between the public interest and personal interest is understood to be conduct (of a public functionary) or failure (of a public functionary to act) which undermines trust in his/her impartiality, or by which a public functionary misuses his/her position in order to obtain unauthorized benefit for him or herself or another individual or legal entity."[1]

This law is not the only example of confused drafting; the United Nations guide for Anti-Corruption Policies states that:[2]

"Most forms of corruption involve the creation or exploitation of some conflict between the professional responsibilities of a corrupt individual and his or her private interests. The acceptance of a bribe creates such a conflict of interest."

In reality, conflict of interest is a situation, not an action — and it is clear that a public official may find him or herself in a conflict of interest situation without actually behaving corruptly. As Speck points out,[3] "The concept of conflict of interest does not refer to actual wrongdoing, but rather to the potential to engage in wrongdoing." Indeed, it is all but inevitable that a public official will face situations where the public interest s/he has been elected or appointed to serve will conflict with other interests to which s/he is subject."

The Policy Brief on the OECD Guidelines for Managing Conflicts of Interest in the Public Sector[4] states that the concept of conflict of interest arises in a multiplicity of situations, such as

- A public official having private business interests in the form of partnerships, shareholdings, board memberships, investments, government contracts, etc.;
- A public official having affiliations with other organizations (e.g., a senior public official sits on the board of a nonprofit organization that receives funding from the official's agency); and
- A public official leaving office to work for a regulated private company or a chief executive taking up a key position in a government agency with a commercial relationship with his/her former company.

Background on Indonesia: Good news…

After 10 years of undertaking spirited—albeit restrained—reform efforts in all sectors, Indonesia has made several praiseworthy achievements, especially in that relatively short timeframe. These achievements include:

- Amending the 1945 Constitution several times, producing improved governance and democratic systems with much weight on the role of the State in supporting the still-developing democratisation process, securing the wealth of citizens, promoting social justice, and protecting the human rights of Indonesia's diverse communities.
- Holding, in a commendably peaceful manner, the first direct general elections in 2004 for the parliament, regional representatives, president and vice president; this was followed by dynamic regional elections for regional parliaments, as well as the regional representatives, governors, majors and regents in more than 400 provinces, cities, and regencies.

Although there were disputes on the election results, these were finally settled by the Courts, and Indonesia's famous street demonstrations that inevitably happened due to the suits turned out to be manageable.

- Creating 30 new state institutions, commissions, and agencies needed to support good governance and anti-corruption systems since the start of reformation in 1998.
- Taking serious and rigorous efforts in the prevention and eradication of corrupt practices to answer the Indonesian public's cry for drastic action. The independent Corruption Eradication Commission (KPK), established in 2004, leads these efforts. That corruption cases were (and for the moment, still are) independently adjudicated by a special Anti-Corruption Court contributed to the effectiveness of the anti-corruption efforts. The special anti-corruption Court sits with a majority of ad hoc judges and decides corruption cases processed by the KPK.
- Creating an open economic environment that boosts investment in a balanced way, taking into consideration socially responsible policies. Modern laws and regulations now exist in the areas of corporation, capital markets, tax, foreign investments, environmental protection, oil and natural gas, mining, infrastructure, anti-monopoly, independent judiciary, and other key areas. Fortunately, Indonesia has not neglected to enact laws and regulations that cater to public interests in the areas of labour, consumer protection, human rights protection, land issues, disclosure of public information, and the like.
- Initiating a comprehensive bureaucratic reform of hundreds of thousands of ineffective public jobs, and applying merit-based programs for public officials. These began with internal reforms within the Department of Finance, the Financial Audit Board, and the Supreme Court.
- Safeguarding the freedom of the press, thereby positioning the Indonesian media among the freest media in the world. The media voices the people's opinions, and directly impacts the performance of the government, parliament and judiciary.
- Applying regional autonomy policies in a country with thousands of islands and a population of more than 220 million. This provides all citizens across Indonesia with equal opportunities and a chance to progress and develop.

…and setbacks

In Transparency International's Corruption Perception Index 2007, Indonesia ranks 144 out of 180; its index is 2.3.[5] The Political and Economic Risk Consultancy (PERC) ranked Indonesia as the third most corrupt country among 13 Asian economies.[6] The International Finance Corporation (IFC) in 2007 ranked Indonesia's investment climate as 123 out of 178.[7]

For the last 10 years after reformation, 82 corruption cases were investigates across the country. Corruption cases investigated and indicted by KPK are basically those involving funds of IDR 1 billion, or those that otherwise adversely affect the economy or state finances, and thus attract significant public concern. Despite the rigorous efforts and effectiveness of the KPK in preventing and combating corruption, corruption is still pervasive across the country. Corruption takes many forms, and includes petty bribery in the provision of basic public services—processing national identity cards and driving licenses, for instance—but also more expensive processes such as land conveyance, construction licenses, business licenses, government tenders; corruption occurs even in the area of public policy making by the parliament or executives.

Reform efforts are perceived to be half-hearted. Lack of funding, political pressure and interests, absence of leadership in many sectors, and cultural constraints often prevent good blue prints from being effectively translated into action.

Despite a genuine aspiration to distribute wealth of the country equally among citizens in rural and remote areas, the regional autonomy programs have resulted in the uncoordinated development and wrong implementation of thousands of local policies. Some of these measures even reinvent or copy the corrupt practices that were standard procedures of Suharto's cronies during the "New Order" administration. Local formal and informal leaders and activists—who seek to secure their region's access to local natural and other resources, following four to five decades during which these resources had been exploited by the central government—receive complaints from the private sector and the public on this proliferation of corrupt practices in the regions.

The country's leadership is in question. Crises call for tough and firm decisions, even though they might sometimes be unpopular. It is a widely made criticism that few days after winning the 2004 election, the current administration began to take decisions with a view to winning the 2009 election. The current administration has been praised for its anti-corruption agenda, although the success of the KPK in the establishment of corruption-prevention measures and sending corrupt public officials to jail is not linked to the performance of the

current administration but rather to the dedication and integrity of the KPK, its commissioners, and its staff.

Most worrying among the reform failures is that the judiciary does not really support the reform of the judiciary. The results have been very underwhelming, even though good laws have been enacted; police, prosecutors, and judges have been trained; resources are available; new systems, technology and governance systems have been introduced. The decisions of the courts indicate that either the quality of the judiciary is still low or that the level of corruption in the law enforcement agencies is still high.

The current global financial crisis will affect the ability of Indonesia to deal with its economic and financial issues; this will also affect the result of the general election in 2009. Economic and political turmoil will also influence how efforts to eradicate corruption and to fight for a clean government will be implemented in the near future.

Regulating conflict of interest

Based on its legal tradition of civil law, Indonesia tends to regulate everything though legislative and executive means. After reformation in 1998, Government and Parliament have promulgated 375 laws, the Government has issued 12 government regulations in-lieu-of-law as well as 927 government regulations; 252 Presidential Regulations, 913 Presidential Decrees, and 45 Presidential Instructions have been issued. Thousands of Ministerial Decisions, Instructions and Directives, and other decisions, instructions, rules, and guidance issued by public officials below the Minister level—plus legal products of state commissions, committees, and boards, either issued to facilitate the implementation of the higher laws and regulations, or simply issued to regulate at that level—have also been put in place.

Conflict of interest is regulated in various laws and regulations, and decisions of legislative, executive, and judicative bodies, and mostly in nonbinding codes of conduct or ethics issued by such bodies. The concept of conflict of interest is present in numerous legal documents such as the

- Indonesian Constitution of 1945, as amended several times;
- Decrees of the People's Consultative Assembly;
- Law on General Election;
- Law on the Ratification of UN Convention against Corruption;
- Law on Regional Autonomy;
- Law on Judicial Commission;

- Law on Supreme Court;
- Law on Power of Judiciary;
- Law on Money Laundering;
- Law on the Commission on Eradication of Corruption;
- Law on Governing of Clean Government and Free from Corruption, Collusion, and Nepotism;
- Law on Indonesian Police Force;
- Law on Public Prosecutor;
- Law on Bribery;
- Law on Corruption;
- Law on the Presidency; and
- Law on the State Ministries.

The laws and regulations basically deal with conflict of interest in respect to: official oaths of public officials; public officials taking on multiple functions; codes of ethics of public officials; conflicts of interest in public function (i.e., issuing a policy in favor of affiliates' interests, having business interests in any company or organization); not taking roles in political parties; not practicing a profession while being a public official (lawyers, public accountants, etc.).

The pace of making new laws and regulations in Indonesia's transformation from a long-repressed to a democratic society is still sadly unmatched by the capacity of institutions and agencies to implement laws and regulations. Reform and anti-corruption efforts can be expected to produce real results only in one of two decades from now.

Since 2007, efforts to regulate conflict of interest have continued and resulted in the promulgation of the Law on Presidency; the Law on State Ministry; the Law on General Election (amended); and the Law on the Composition and Position of the Parliament and Regional Representative Board; this last law was being discussed in Parliament in November 2008.

Most common conflicts of interest

In Indonesia, the most common conflict of interest situations involve:

- A public official designs, sets up, or issues a public policy, or makes a decision favorable to a business he/she directly or indirectly owns or controls, or that he/she expects to acquire or control;
- A public official designs, sets up, or issues a public policy or makes a decision favorable to a business of his affiliates (political, religious, family, ethnic, place of living, association, professional), regardless of

whether or not there is a conflict of economic or financial interest in such an act;

- A public official puts himself in a position that potentially triggers a conflict between his public duties and his personal interests; the official may not necessarily intend to engage in unethical conduct, and policies or mechanisms for preventing or managing such potential conflicts may or may not be in place;
- A public official receives money, goods, or services without incurring any immediate obligation to design, set up or issue a favorable policy or decision; however, such gifts still give rise to a psychological situation, where the public official feels "obliged" to return the favor in the future;
- A public official holds a position, role or interest in a corporation whose business depends on the policies or decisions of the official or his/her fellow public officials;
- A public official holds multiple positions, which may create a conflict or potential conflict between them.

The practice of dealing with conflict of interest: Business as usual

During the Suharto regime, corrupt acts involving collusion, cronyism, and conflicts of interest were standard conduct of most public officials. Family members and cronies of the Suharto Government controlled tenders for public procurement of goods and services. Suharto family members and his cronies marked up prices of goods and services, and issued businesses licenses, especially in the area of natural resources and infrastructure. The parliament, executive and judiciary, mass media and political parties were government controlled, and criticizing Suharto or his policies meant inviting trouble.

One would expect that reformation—which brought free, direct, and transparent general elections; a free press, academia, and public; as well as good governance and systems of checks and balances—would also bring clear regulations of conflict of interest, including effective prevention, and sanctions for perpetrators. Although progress has been made, collusion still compromises many government tenders, projects are still being marked-up and many public officials still hold multiple positions.

Conflict of interest is still pervasive where public officials have direct or indirect business interests in big corporations. Mr. Jusuf Kalla, Indonesia's Vice President, has interests in several corporations, including the Bukaka Group and the Bosowa Group. Mr. Aburizal Bakrie, currently Coordinating Minister of

People's Welfare (formerly the Coordinating Minister for Economic Affairs) has interests in several corporations including Bumi Resources, KPC, and Bakrie Telecom. Both individuals have won several government projects in toll road projects, transportation, gas, mining, power generation, and telecommunication amounting to several billion USD. Messrs. Kalla and Bakrie are respectively chair and co-chair of the Golongan Karya (Golkar) Party, a party that supported Suharto's repressive regime for the last 32 years of his administration.

For the last several years, the Bakrie group has been trying to convince the Government that a mud explosion in Sidoarjo, East Java, that paralyzed thousands of hectares of land was a natural disaster and not a technical error caused by an oil operation of one of their affiliates. If it were declared as a national natural disaster, the operator of the mines would be freed from any liabilities. In a more recent case, shortly after the global economic crisis started to affect the Indonesian capital markets, Bumi Resources, a member of Bakrie Group, encountered difficulties in servicing its debts. Media reports suggest that the Bakrie Group tried to influence the Minister of Finance and the Capital Markets authority to suspend trading of Bumi's shares during the negotiations with a buyer. The Bakrie Group is considering initiating legal action against an Indonesian media company. Tempo Magazine, in its November 2008 edition, reported "Jusuf Kalla from the offices of the Vice President said clearly: what's wrong with the Government helping (Bakrie Group)? He was quoted to say that the Bakrie Group is a national asset."

In another interesting case, one member of Parliament reported to KPK that he and his fellow Parliamentarians received money for the purpose of winning the election of the Senior Deputy Governor of the Central Bank. The Senior Deputy Governor refused to admit it, but media reports suggest that a member of the banking industry may have made the payments, hoping to get favorable decisions in the future.

Establishing an appropriate prevention program

Reformists in the government and other stakeholders are aware that conflict of interest problems will not disappear through passage of a single regulation. Comprehensive measures are necessary. The Government initiated regulatory reform in 2007, starting with the Department of Finance, the Supreme Audit Board, and the Supreme Court. One of the main programs will be organizational reform, which will involve launching programs to increase discipline amongst public officials, including avoiding multifunction and increasing public officials' salaries to reduce abuses arising from conflict of interest situations.

The ADB/OEDC Anti-Corruption Initiative for Asia and the Pacific held a regional technical seminar on Preventing and Managing Conflict of Interest in Jakarta in August 2007. Since then, KPK and development partners have been in communication to prepare a more comprehensive study with the purpose of: mapping COI rules and regulations; increasing public knowledge of the concept of preventing COI; issuing a new and more effective rule specifically on COI; establishing oversight agencies on COI in practice; and setting out effective disciplinary measures against non-complying public officials. The study is expected to be completed in 2009, and has the potential to contribute significantly to government reform programs.

Policy recommendations

Indonesia has ratified the UN Convention against Corruption (UNCAC), and a domestic law for its implementation has been enacted. The UN Convention contains important provisions on conflict of interest that reflect global governance and business standards. Policy efforts should start with a mapping activity on the laws and regulations that must be adjusted to the principles of the Convention. Subsequently, pressure needs to be exerted to force Government and Parliament to comply with the UN Convention.

The process to adjust the laws and regulations as set out above needs considerable time and effort. Pending the completion of these efforts, there should be a general rule applied to all public officials or prospective public officials, obliging them to

- prior to election and appointment processes, declare and register publicly all business and other interests that he/she and family and affiliates own or control;
- update any changes to such interests that intervene in the course of their function in public office;
- declare arising conflicts of interest to a responsible body;
- abstain from making any decision in a potential direct or indirect conflict of interest situation;
- subject themselves to an investigation by the responsible body when a conflict of interest occurs; and
- comply with the recommendations or disciplinary actions administered by the responsible body.

Socialization to, and oversight measures taken by, stakeholders are important. The current laws and regulations appear sufficient to make public all important information that relates to national interests. For example, all

information on the government procurement of goods and services shall be made public, including pricing policies and benchmarking processes to the open market. The public shall be able to point out when a process is not in line with the benchmarks generally available in the market, and the body or agency in charge of monitoring conflict of interest shall be able to follow up any reports from the public, and take necessary measures or actions.

NOTES

1 See Quentin Reed: *Sitting on the Fence, Conflict of Interest and How To Regulate Them.* U4 Issue 6.2008. Available at www.cmi.no/publications/file/?3160=sitting-on-the-fence

2 United Nations Office on Drugs and Crime: *United Nations Anti-Corruption Toolkit*, pp. 15–16. The document is available at www.unodc.org/documents/corruption/publications_toolkit_sep04.pdf

3 Quoted after Quentin Reed: Sitting on the Fence, Conflict of Interest and How To Regulate Them (see note 1 above).

4 September 2005. Available at www.oecd.org/dataoecd/31/15/36587312.pdf

5 The CPI is available at www.transparency.org/policy_research/surveys_indices/cpi

6 www.asiarisk.com

7 The index is available at www.doingbusiness.org/economyrankings/

Auditors' Conflicts—Independence in the Audit of Financial Statements

Navita Srikant, Partner and National Leader, Fraud Investigation and Dispute Services, Ernst & Young Pvt Ltd., Mumbai, India

Expert views can be valuable, and help people formulate opinions. Quite often, however, these experts face conflicts of interest between their professional obligations and their own self-interest to provide good advice.

"Integrity needs no rules" and such conflict is difficult to define: a situation which can cause conflict for one person may not be a problem for another. The majority of professionals are unaware of the gradual accumulation of pressures on them to slant their conclusions—a process which has been characterized as *moral seduction.*

Given what we now know generally about motivated reasoning and self-serving biases in human cognition—and specifically about the incentive and accountability matrix within which auditors work (*Bazerman, Morgan, & Loewenstein, 1997*)—we should view personal testimonials of auditor independence with scepticism.

Evidence has suggested that intentional corruption is probably the exception, and that unconscious bias is far more pervasive. This distinction between conscious corruption and unconscious bias is important, because the two respond to different incentives and operate in different ways.

Most professionals feel that their decisions are justified and that concerns about conflicts of interest are overblown by ignorant outsiders who malign them unfairly. Perhaps the most notable feature of the psychological processes at work in conflicts of interest is that they can occur without any conscious intention to indulge in corruption. Psychological research on the impact of motivated reasoning and self-serving biases questions the validity of this assumption. The evolution of several audit-related professional services over time and the impact of non-audit fees have also played a significant role in the discussion between Independence and conflict of interest.

In 1978 the SEC required companies to disclose any non-audit services their auditors performed for them if and when the fees paid to the auditor for non-audit services were at least 3% of the audit fees paid. However, this requirement was repealed in 1982 by the SEC, which concluded that the required disclosure "was not generally of sufficient utility to investors to justify continuation," despite evidence showing that knowledge of a consulting relationship creates a perceived lack of auditor independence.

Non-audit services proved to be yet another important growth area for accounting firms. The Public Oversight Board Panel on Audit Effectiveness Reports and Recommendations in 2002 reported that by 1999, fees for non-audit services had grown to 66% of revenues and 70% of profits for the major accounting firms.

Much has been written and spoken about the loss of public confidence in financial reporting during the late 1990s and early 2000s, and the auditor's performance of this gatekeeper role. A few factors could be taken into consideration to understand this significant erosion of trust:

- The rise of non-audit, consulting services: Revenues from activities—such as systems design, tax planning, assistance with data processing procedures, and a host of other high-margin advisory services—became increasingly important. In many cases, clients were paying their auditors more for consulting than for the financial statement audit. As a consequence, firms began to see the lower-margin audit as a hindrance to more lucrative consulting engagements.
- Downward pressure on auditing fees: Firms faced considerable pressure to keep the audit fee low, or risk losing both their audit and (more profitable) non-audit relationships with clients. In a growing market, clients viewed the audit opinion as merely another standardized commodity to be purchased as economically as possible.
- Increased reliance on more cost-efficient means of auditing: The tactic of using the audit to gain entry to other work, coupled with the difficulty in raising audit fees, meant that the costs of auditing had to be controlled. That, in turn, led to more emphasis on risk-based auditing, the theory under which auditors plans their work based on judgments about which aspects of the client's business are the most likely prone to error or fraud. In the areas of perceived low risk, the auditor relies more heavily on internal controls and management representations. Though theoretically strong, this process—if not judiciously applied—can have disastrous consequences, particularly if the underlying judgment about risk turns out to be incorrect. An example of this is WorldCom.

What is independence?

Various legal and other definitions are available for "independence The Code of Ethics for Professional Accountants, issued by International Federation of Accountants (IFAC), distinguishes independence of mind and independence of appearance. Per their definition, "independence" is:

- **Independence of mind** - the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity and exercise objectivity and professional scepticism; and
- **Independence in appearance** - the avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional scepticism had been compromised."

The code further identifies five specific threats to auditor independence:

- **Self-interest threats** – Partner or associate benefiting from a financial interest in an audit client.
  i. Direct financial interest or materially significant indirect financial interest in a client,
  ii. Loan or guarantee to or from the concerned client,
  iii. Undue dependence on a client's fees and, hence, concerns about losing the engagement,
  iv. Close business relationship with an audit client, or potential employment with the client, and
  v. Contingent fees for the audit engagement.
- **Self-review threats** – Reviewing of any judgment or conclusion reached in a previous audit or non-audit engagement, or when a member of the audit team was previously a director or senior employee of the client.
  i. When an auditor has recently been a director or senior officer of the company, and
  ii. When auditors perform services that are themselves subject matters of audit.
- **Advocacy threats** – When an auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is being compromised (e.g., when an auditor deals with shares or securities of the audited company, or becomes the client's advocate in litigation and third-party disputes).
- **Familiarity threats** – When auditors form relationships with the client where they end up being too sympathetic to the client's interests. This can occur in many ways:
  i. Close relative of the audit team working in a senior position in the client company,

ii. Former partner of the audit firm being a director or senior employee of the client,
iii. Long association between specific auditors and their specific client counterparts, and
iv. Acceptance of significant gifts or hospitality from the client company, its directors or employees.

– **Intimidation threats** – When auditors are deterred from acting objectively with an adequate degree of professional scepticism. Basically, this could occur because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.

Regulation in the Indian Context

Various countries have created regulations on auditor conflict and independence. In India, both the Companies Act of 1956 and the Chartered Accountants Act of 1949 provide restrictions to ensure independence of auditors.

Following are few key examples from Indian regulatory context on the independence of chartered accountants (CA) as auditors: Section 226 of the Companies Act prohibits the appointment of a CA as auditor if there exists certain relationships or indebtedness to the Company or the auditor is a shareholder, while section 334 of the Companies Act also provides for special resolutions to be adopted if the appointed auditor has relationships with any director or managers in the company.

Under the CA Act, the areas of restrictions are: fees and kind of fees that can be paid to the auditor which are not success based, services that can be provided (liquidator, internal auditor, management consultant, etc.) and if substantial interest or director or in the employment as an officer in the company either himself or through partner or relative.

Resolving Conflict of Interest

Given the cognitive and political barriers to solving the problems created by conflicts of interest, it is unlikely that society will ever entirely eliminate them. Nevertheless, that does not mean that it is impossible to limit their reach.

Auditor independence is the cornerstone upon which the audit profession has been built, and indeed, discharges its duty to its clients and the market at large. The key characteristic of this independence is the state of mind of the auditor. This must include integrity, strength of character to stand up for what is right, and freedom from undue influence with a positive independent outlook.

Understandably, as we see all manner of corporate collapse, including a global audit firm, the question of audit independence must be challenged.

A number of theories have been written and talked about in this context:

- Auditors should perform audits and no other services.
- An audit firm should be hired for a fixed period, perhaps 5 years.
- All parties involved in the audit, executives and staff alike, should be prohibited from taking jobs with the firms they audit.
- Auditors should make a set of independent assessments, rather than simply ratify the accounting of the client firm.
- The auditor should be chosen not by company management but by the audit committee of the board of directors.

Conclusion

Abraham Lincoln once said: "You cannot build character and courage by taking away a man's initiative and independence". This saying holds true in the auditing world as well: initiative is required by auditors to take right decisions, keeping in mind the facts—and walking the lane of independence is a very essential characteristic of this profession.

However, like so many other professional issues this issue requires rigorous debate, robust research and, ultimately clears professional judgment. Structures and processes will certainly support both the fact and perception of auditor independence, but in the final analysis it is the integrity of the auditor which ensures that correct judgment calls are made.

Conflict of Interest in the Transport Sector

William D. O. Paterson, Consultant, former Lead Infrastructure Specialist with the World Bank

In the realm of business, public officials commonly interact or deal with suppliers, contractors, and consultants in the private sector on a regular basis in the performance of their ordinary duties. These situations of interaction, which in themselves are natural and a necessary part of business dealings, can also have the potential for officials to experience a conflict between private interests and the public interest, which may lead to corrupt activity.

It is important when reviewing situations where conflict of interest can arise, to distinguish this situation from actual corrupt behavior because corrupt behavior does not necessarily follow from the situation. The aim in managing and controlling conflicts of interest is therefore to reduce the likelihood of conflict of interest situations, and to avoid a conflict situation leading to corrupt behaviour.

In this presentation, we will be considering the kind of situations that arise in an important public sector, which is also one of the most vulnerable to corruption—the transport sector.

Sources of conflict of interest

In most transactions between the public and private sectors, there is a familiar array of controls over various facets of the transaction—through internal control systems, internal audit, external audit, and increasingly through a third party monitor not employed by the government. However, provisions to limit the private interests of officials participating in the process are much less common in many developing countries.

In the case of the transport sector, and many other infrastructure sectors also, public officials will often be qualified technical professionals in the sector. As such, they will usually have a network of peers, developed partly through their academic and professional training, and partly through trade and professional associations, which run in parallel to their public employment. Furthermore, some may well come from extended families with financial interests in supply,

construction or consulting firms—or have strong geographical or political ties to a region—that may induce indirect benefits or cause indirect influence over decisions. Guidelines for when an official should recuse themselves from certain situations or decisions are therefore important but difficult to devise.

Conflict of interest situations can also arise for any third party group brought in to monitor the situation, especially if the private sector or public officials capture the situation in a scheme to cover corrupt activities and to co-opt or influence the third party monitor. Third party monitors may be provided with transportation, accommodation, entertainment, or even direct remuneration of varying levels—usually through the private sector—in order to influence their judgment. While some of these may begin as simple administrative arrangements, they may easily be extended in scope or amount as bribes, and in some forms may later be used for blackmail or coercion purposes, in order to maintain secrecy over the scheme and influence over the decisions being made.

The following threat areas need to be addressed by provisions to control conflict of interest:

1. *Recruitment and appointment of staff*: A critical tool in corrupt schemes is often the use of patronage to place individuals who are well connected to local officials or influential firms into management staff positions responsible for business decisions such as procurement, payment authorization, budget allocation, etc. Thus, staff recruitment should include provisions for declaration and review of the commercial and political ties and interests of a recruit or appointee. For transparency, this information might also be disclosed within appropriate guidelines.
2. *Professional or technical associations*: A declaration of membership and positions of responsibility held in technical and professional associations, or nonprofit organizations that may receive government funding, should be made and updated regularly for mid-level and senior staff. Ideally, membership in such organizations may reduce the risks when there are strong ethical and professional standards in the organization; however, in other situations the participation could induce opportunities for market sharing and cartel-type behaviour if allowed to pass unchecked.
3. *Security concerns*: In areas of security risk, a mechanism of internal transparency is needed to ensure that staff do not compromise quality and decisions out of concern for safety and security, and that the actions taken to address the risks are appropriate and duly disclosed.

4. *Assets and private interests*: The practice of requiring staff in decision-making positions to make regularly updated declarations of financial assets and commercial interests has been growing, and provides a crucially important tool for transparency and control of potential conflicts of interest. The effective application of asset declarations, however, also requires careful attention by management to ensure that staff actually recuse themselves from situations where a conflict of interest might arise, and that this is not left to become a pro forma exercise.
5. *Post-public-employment issues*: Significant opportunities for conflict of interest arise with former public officials who take up employment in organizations which work in the same sphere or may be retained by the government to provide services of some kind. Specific provisions for a "cooling-down" period and arms-length relationships are necessary for the rules to be clear and accepted.

For the private sector, there are many stages in the value chain or project cycle where a potential conflict of interest could be exploited. General facilitation through small or large gifts, hospitality and entertainment, including sporting events such as golf, have all been used to develop a spontaneous and reliable relationship with public officials which is expected to yield payback through favors in critical stages of the project cycle. The stages that are the most vulnerable are those where significant discretion is involved or where transparency is lacking in the processing of information.

Specific vulnerabilities arising from conflict of interest

In procurement, the most vulnerable stages are usually the prequalification, evaluation, and contract award stages. In addition to controls to ensure fair competition and transparency, specific actions should be taken to ensure that individual public staff involved in evaluations and decisions are fair and independent—and free from commercial interest or connection with any of the competing firms, with a specific declaration of any specific connections which might constitute a conflict of interest. In the implementation stage, the potential for conflicts of interest is almost as high, because a firm can exploit relationships with supervising staff to have deficient work accepted or to inflate contract variations, using the savings or proceeds to benefit both the supervisor and the supplying firm.

As noted earlier, even third parties who are intended to provide an independent monitoring function can be vulnerable if key provisions are not made to prevent or minimize conflict of interest situations. For inspectors and

supervisors, provisions should preserve the independence of mobility to, from and around the site, subsistence and work operations.

For auditors, a conflict of interest situation arises, especially for a firm which has been incumbent for some time, in the judgment distinguishing substantial variances from minor ones, and in the hope for continuity of business from year to year.

Similarly, even financing agencies can face conflicts of interest in the oversight of programs, through pressure to expedite clearances or financing to enhance portfolio performance, perhaps at the expense of quality or governance issues.

Preventing and managing conflict of interest

An interesting example, where constructive forces of partnership counter-balance the potential for conflicts of interest, is the multi-stakeholder monitoring group in the Philippines road sector. There, a partnership between civil society, nongovernment organizations, the private sector, and the public implementing agency was formed to tackle an array of quality and governance issues. The partnership structure facilitates access to information and sites, and constructive responses. To preserve impartiality as a watchdog, however, the public agency was excluded from critical executive actions such as voting by the board.

These situations, which commonly arise in infrastructure sector processes, require special attention when developing conflict of interest provisions, especially when adapting general provisions to control of conflict of interest. As the OECD Gifts and Gratuities Checklist expresses,[1] the test of evaluating a gift or situation comprises the following aspects: Is the advantage a genuine appreciation and not solicited? Will I maintain independence in my job in the future? Am I free of obligation to do anything in return? And am I prepared to declare it transparently to my colleagues?

NOTES

1 More information on this concept is available in *Managing Conflict of Interest in the Public Sector: A Toolkit*. OECD 2005, p. 43. A free read-only version is available at browse.oecdbookshop.org/oecd/pdfs/browseit/4205121e.pdf