

Economic crime: people, culture and controls

The 4th biennial Global Economic Crime Survey
United Kingdom



Introduction and demographics

PricewaterhouseCoopers has published the Global Economic Crime Survey and its accompanying UK Country Report every two years since 2001. It is a comprehensive assessment of the nature and impact of economic crime on businesses worldwide and provides an in-depth look at the trends and developments associated with this issue.

5,428 organisations globally were interviewed for the Survey, of which nearly one in five were listed in the US and one third were listed in other territories. In the UK, 302 organisations were interviewed, of which 56% were listed on the UK or other Stock Exchanges. It is the findings from these respondents which provide the statistics for the UK Country Report.

Trends in economic crime

Our 2007 survey reveals that corruption and bribery is the most rapidly growing form of economic crime, with nearly twice as many UK organisations reporting this type of fraud compared to our last survey. Notably, a fifth of organisations from our global survey reported being asked to pay a bribe in the course of business, while in the UK over a tenth of respondents stated

that they had lost a business opportunity to a competitor who had paid a bribe.

Of particular concern are the fraud threats in the emerging markets. A keen awareness of the risks presented by doing business within the E7¹, together with new, adaptable and robust controls are crucial to the success of firms who wish to benefit from, and operate safely within, these rapidly growing markets.

Our survey shows that the risk of economic crime in these markets was a significant factor in about half of investment decisions. Respondents perceived the greatest concern to be corruption, followed by a lack of faith in the legal environment.

Prevention and detection methods that may work in the developed economies cannot necessarily be relied upon when operating in the emerging markets. There are many cultural factors which exist and which need to be taken into account as part of UK companies' anti-fraud policies.

A consistent theme which we have seen throughout our surveys is that companies underestimate the risk of being victims to fraud. The 2007 survey shows that while 48% of UK companies suffer economic crime, only 17% believe that they are 'quite' or 'very likely' to be subject to it

over the next two years. This large gap between perception and reality is even more difficult to understand given that UK companies which reported being victims of fraud suffered, on average, 15 incidents over the previous two years – almost twice the global average and nearly three times more than the average in Western Europe.

The failure to institute adequate anti-bribery controls exposes companies to significant legal and regulatory risks. The occurrence – or even the allegation of corrupt conduct – can have a pervasive impact out of all proportion to the scale of the alleged corrupt act, calling into question the integrity of management and the effectiveness of internal controls and damaging a company's reputation. Where corruption is proven, the consequences for those involved can include imprisonment, heavy fines and confiscation of profits corruptly earned, potential exclusion from future business, as well as the collateral costs of remediation efforts required to mitigate the risk of recurrence and satisfy regulatory requirements. Companies are well advised, particularly those which do business in high risk countries or sectors, to look proactively and honestly at how effectively they are managing corruption risk and to take robust remedial action where gaps are identified.

Fig 1 What is the collateral cost of fraud?

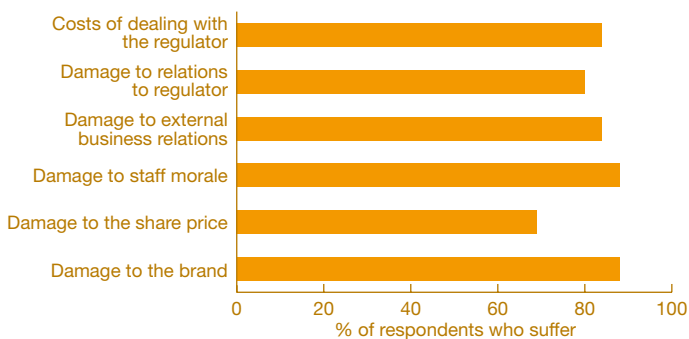
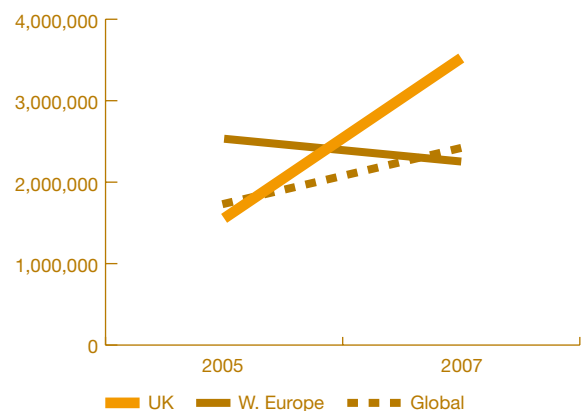


Fig 2 Mean loss US\$ – All frauds



1 E7 represents the seven emerging economies of Brazil, China, India, Indonesia, Mexico, Russia and Turkey.

Furthermore, as a result of the increased number of frauds suffered, the average direct cost of economic crime to victim corporations in the UK is now £1.75 million (compared to £0.8 million in our last survey) and a further £0.75 million of management costs. But, as our survey shows, the direct cost is only part of the equation.

The costs of economic crime to UK businesses

While the direct losses suffered to fraud are considerable, this is only part of the true cost. When fraud occurs, organisations also suffer additional, collateral damage which can be significant.

Almost half (48%) of UK companies reported being a victim of fraud. This is higher than both the Global Survey respondents (43%) and those in Western Europe (38%). It is noteworthy that 52% of UK respondents claimed not to have been subject to fraud whereas those that were victims reported a large increase in the number of frauds suffered. One question to consider is whether the 52% of UK companies that claim not to have suffered fraud have better fraud prevention controls or whether they are yet to detect or admit it.

Economic Crime in the UK – a changing environment

The most widely reported form of crime in the UK continues to be asset misappropriation. However accounting fraud, intellectual property infringement, corruption and bribery and money laundering are all very prevalent, too.

As figure 4 below shows, UK organisations reported higher levels of fraud than across Western Europe and the rest of the world in almost all categories cited. It may be that the UK’s investment in anti-fraud controls (discussed further below) gives rise to higher detection rates.

A widening and changing context

Increasingly, UK companies are exposed to threats from economic crime taking place in the global landscape. While UK respondents reported external party involvement in 75% of economic crime cases, in nearly half of these cases the external party was based outside the UK.

Accounting fraud

We recently investigated an accounting fraud at a UK company with subsidiaries in an emerging market. We found that the balance sheet contained numerous fictitious assets and understated liabilities as a result of overstatement of the company’s profits over a period of four years. The subsidiary was capitalising costs and overstating sales. The investigation resulted in a £50m write off.

Corruption and Bribery within the Engineering and Construction Industry

Surveys by Transparency International have found that Public Works and Construction was regarded as the business sector in which senior public officials demanding or accepting bribes were most likely to be found, and that the bribes demanded in the sector were likely to be the largest. Our Global Survey found that the Engineering and Construction industries suffer the second largest amount of fraud in any industry sector. This has serious implications for large construction projects such as the 2012 Olympics and London’s Cross Rail project.

Fig 3 Reported incidences of economic crime

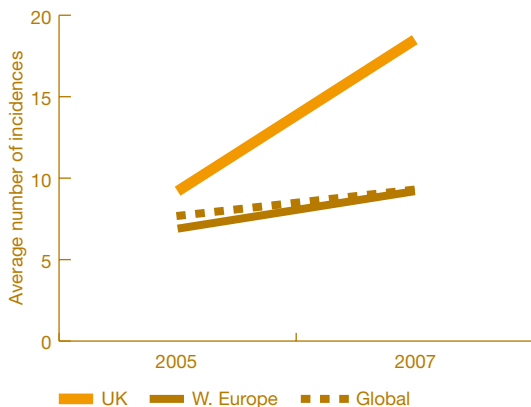
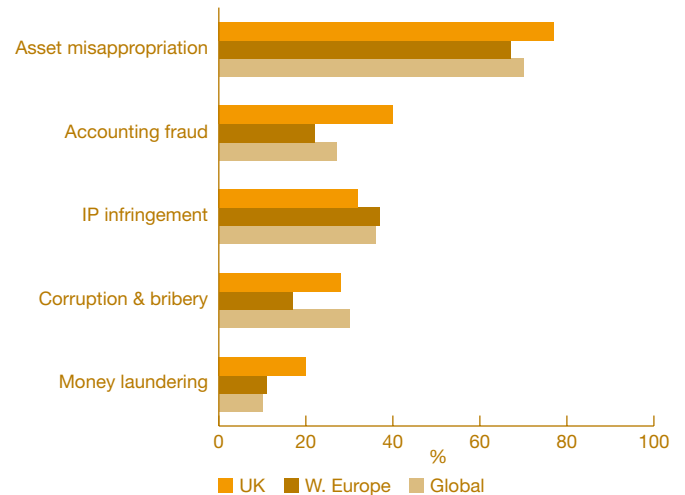


Fig 4 Fraud suffered by victim organisations



China

The most common perceived form of economic crime of UK respondents operating in China was corruption and bribery, highlighted by over a quarter of responses, followed closely by Intellectual Property ('IP') infringement. Despite these concerns, almost one in three respondents had no specific actions planned to mitigate either corruption and bribery, or IP infringement risks.

China, together with a number of other emerging countries, represents an attractive proposition for UK companies both as a low cost production base and as a vast consumer market. But there are large cultural (and other) differences

One important cultural factor when doing business in China is 'Guanxi' – a network or relationship – where gifts and hospitality are often involved as the relationship is developed. It is essential to develop the right Guanxi because with strong, often one-to-one, personal relationships in place the business is more likely to succeed. Conversely, without those relationships, a company may find it difficult to succeed. The problem is, of course, that, in the West, gifts and hospitality could be seen as bribes.

which exist in these territories and which UK companies need to be alert to. These include a very strong, hierarchical governance structure where internal controls can be more easily circumvented, and a way of doing business which is very different to the UK. Consequently, UK companies cannot simply rely on the internal controls that may work here – they must be adapted for overseas subsidiaries.

Counter measures adopted

The good news is that anti-fraud controls within UK companies for their domestic business appear to be increasing, with a greater incidence of specific fraud training, fraud analysis techniques and whistle-blowing programmes featuring in the 2007 Survey. Further, UK companies appear to be at the forefront of implementing anti-corruption control programmes, prevalent in over 40% of UK companies compared to less than a third of both Western European and global respondents. The adoption of such measures is encouraged, though they require constant improvement and appraisal in the face of the risks presented by new markets, changing structures and innovative fraudsters.

In concert with the proactive steps taken by many UK firms to tackle the problem

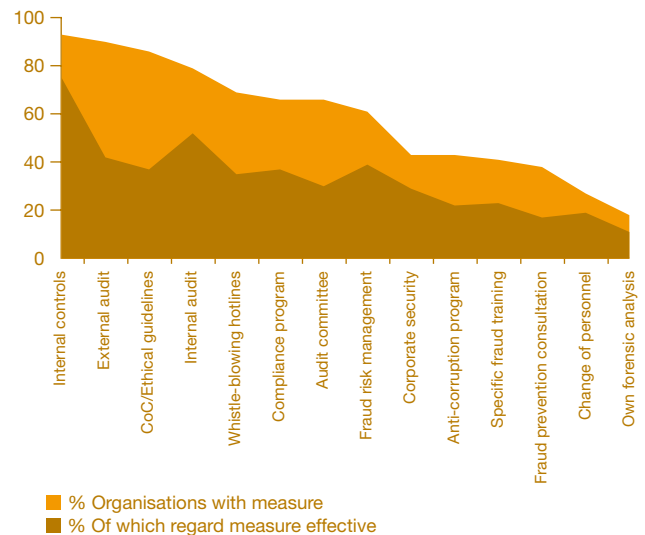
of economic crime, equally important is the ability to react appropriately to fraud should it occur. Companies with clear fraud response plans in place, and which outline actions to take place, are obviously better placed to address the risks posed by economic crime when it does occur.

Fraud prevention and detection strategies

Of real concern, however, as noted earlier, is that UK companies continue to underestimate the probability of being victims to fraud. Only 17% believed they were either 'quite' or 'very likely' to suffer a financial crime, whereas our survey shows that 48% actually have. The UK does, however, appear to be more proactive than other countries in Europe in dealing with the problem, through the development of new controls or the strengthening of existing controls. With an average of ten key anti-fraud controls in place, UK respondents reported having more prevention and detection measures, on average, than respondents in Western Europe and the rest of the world.

Among the UK's detection/prevention measures, those most popular were internal controls, external audit, ethical guidelines, codes of conduct and internal

Fig 5 Prevention/detection measure – Perceived effectiveness



audit. We note however that the prevention/detection measures with the widest differential between implementation rates

and assessed effectiveness are codes of conduct/ethical guidelines, whistle-blowing hotlines and anti-corruption programmes, possibly suggesting uneven implementation and variable efficiency.

survey – there are now more than twice as many UK firms with such a system in place than in Western Europe. However, only 51% of respondents rated it as effective and the proportion of the most serious incidences of fraud detected by this means fell to only 3%. Conversely there was a marked increase (23%) in the proportion of detections by way of informal tip-off. This may suggest that employees prefer to go through unofficial channels, perhaps because of a greater perceived sense of anonymity or the existence of personal relationships (i.e. trust) which ease the making of such disclosures.

Tone at the top

The tone set at the top of an organisation influences the way its employees behave. A code of conduct can help to articulate this by describing the company's expectations and, specifically, what is considered to constitute fraudulent behaviour. It should apply internally and externally; that is, both to employees and to anyone who has significant influence over the relationships and dealings of the company. But codes of conduct have to be reinforced by regular messages from the CEO and the Board.

Senior management's response to fraud is key. The tone at the top is not just about senior management behaving in an ethical and law-abiding manner themselves, but also about the message which is conveyed when responding to a fraud perpetrated by employees, at all levels, so that they do not appear to be either condoning or disregarding such conduct. Cases of turning a blind eye or one rule for one, another for the rest, will quickly disseminate through the organisation and impede a unified response to preventing, detecting and reacting to economic crime.

A slight decline in the proportion of the most serious instances of fraud detected by internal audit compared with 2005 is probably a reflection of the increased resources vested in other specialist, related functions such as corporate security and compliance. Nevertheless internal audit remains the single most important way of detecting economic crime, with nearly a fifth of all cases being discovered by this means. Overall corporate functions, including risk management, corporate security, external audit, internal audit and change of personnel account for the largest overall detection rate of 40%. This category is followed by accidental discovery, including internal tip-off, whistle-blowing and by accident, with external methods of discovery including law enforcement investigation and external tip off, last. 7% of all discoveries are put down to 'accident'.

Whistle-blowing

There was a 21% increase in the number of UK firms implementing a whistle-blowing system compared with our last

Whistle-blowing policy

For a whistle-blowing policy to be beneficial it should provide employees, and others, with an appropriate mechanism to communicate concerns to the audit committee about potential violations of the code of conduct, including unethical behaviour and actual or suspected fraud, without fear of retribution. It is important that the tone at the top instils confidence and encourages the reporting of alleged incidents of misconduct. It is equally important that substantive allegations are, and are seen to be, investigated and followed up.

Fig 6 Means of detection of the most serious frauds – UK companies



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Knowing your enemy (including those in foreign countries)

While it is true that there has been a significant increase in the involvement of external parties in the commission of economic crime against UK companies, the preponderance of serious fraud perpetrators remain those same organisations' own employees and agents. The proportion of serious fraud perpetrated by external people with no relation to the company is similar to the findings of our 2005 Survey, while economic crime perpetrated by external people with a business relationship with the organisation (e.g., customers/suppliers/contractors) has declined. This perhaps reflects the main focus of a company's control efforts on external relationships with known entities, and also indicates the inherent difficulties in controlling both employee fraud and the threat from unknown organised criminals. Chief amongst the control of such risks is pre-employment screening, both for new joiners to organisations and also promotions into more senior positions amongst existing staff.

Pre-Employment Screening

Our experience shows that up to as many as one in four curriculum vitae contain serious discrepancies.

Pre-Employment Screening is the verification of a candidate's background for employment purposes. In the majority of proven internal fraud cases, in our experience there were signs in the employee's background which, had screening been conducted, may have precluded their employment. The screening of potential employees has proven to be a valuable risk management tool and is considered by experts to be an effective way of minimising and guarding against potential security risks by identifying undesirable employees before they join an organisation. However, given that a significant percentage of existing employees are capable of committing fraud if the opportunity presents itself, pre-employment screening is not a substitute for robust internal controls.

The increase in the proportion of fraud perpetrated by individuals within the organisation may arise as a result of structural changes which many UK companies have experienced, as controls are often weakened during periods of transition, when gaps within the control environment occur and opportunities to commit fraud are created.

The profile of the typical fraudster has also changed since our last survey, with a significant reduction (23%) in senior management fraud and a corresponding increase in the proportion of fraud perpetrated by non-management/'other employees' – now 60% of the total. Consequently, the typical fraudster is now 36 years old, more highly educated (twice as many hold a postgraduate degree than in 2005) and will have been with the organisation and in position for just under two years, perhaps reflecting the more mobile labour market.

The tone at the top was an issue in 2005, with a significant percentage of offences being perpetrated by senior management. The offending population within organisations in 2007, however,

Fig 7 Internal perpetrator – time in company

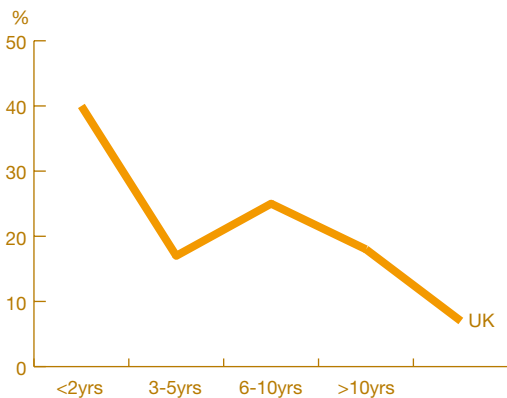
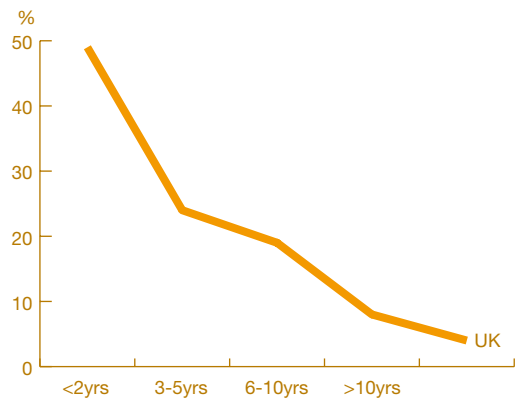


Fig 8 Internal perpetrator – time in position



appears to be principally younger, more transient 'other employees', frequently on short-term or temporary contracts. This raises significant issues for organisations regarding how they ensure and encourage commitment from such staff, and how it gets them to buy into the incumbent code of conduct and ethical guidelines. We have already seen that these prevention measures are regarded by respondents as the least effective of those commented on.

The reasons why fraud is committed depend on the nature of the individuals themselves, with the top motivators and facilitators being 'easy to tempt', and having a 'lack of awareness of values or wrongdoing', together with an expensive lifestyle and a denial of the financial consequences of economic crime. The personal characteristics of lacking awareness of values/wrongdoing and a denial of financial consequences have increased markedly in their significance as reasons/justifications for fraud since our survey in 2005. Almost twice as many cases were found to be related to fear of dismissal/layoff – again perhaps relating to the structural changes occurring within

organisations, redundancies and the use of temporary staff. The proportion of incidents related to management override and weak internal controls have declined by around one third in each case, a possible reflection of improved anti-fraud controls and a hardening of attitudes against economic crime committed by senior corporate officers.

The regulatory environment

Compliance with Sarbanes-Oxley was the biggest reason for organisations introducing measures against economic crime, occurring in 94% of cases, while advice from external consultants and local legislation were the next most important factors at 46% and 45% of cases respectively. Actually suffering from fraud was a reason for implementing prevention measures in only 28% of respondents. Respondents also report a large increase in Sarbox awareness over the previous two years, although this was accompanied by a decline in the perceived level of knowledge with regard to economic crime causes and prevention.

When UK respondents were polled on whether they felt the introduction of the new Fraud Act had helped them better understand and therefore manage the risk of fraud effectively, half of them said it had. This is an encouraging statistic. However, a similar proportion said that the implementation of the Act would not make them more likely to report fraud.

This was supported by the results of questions posed in relation to the actions which are taken against fraudsters – with under half of UK companies being likely to bring civil or criminal charges in response to economic crime. They were instead more likely to dismiss, reprimand, or take no action against perpetrators. This may be a reflection of the types of offences being perpetrated, or the relative costs (cost-benefit analysis) of pursuing the matter – but it is, nonetheless, a worrying sign. However, where the successful criminal prosecution of offenders did occur, the penalties in the UK were more severe than elsewhere in Europe, with convicted persons more likely to receive short prison sentences as opposed to fines or the return of stolen assets.

Fig 9 Fraud motivators/facilitators



‘the typical fraudster is now 36 years old, more highly educated... and will have been with the organisation and in position for just under two years’

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