



 **ERNST & YOUNG**

*Quality In Everything We Do*

# Fraud

## The Unmanaged Risk

8th Global Survey



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“In the long run,” Bush told business leaders on Wall Street, “there’s no capitalism without conscience ...My administration will do everything in our power to end the days of cooking the books, shading the truth, and breaking our laws.”

# Foreword



By its very nature, fraud involves deceit and concealment. As a consequence, those charged with corporate governance generally have little practical information about fraud. The purpose of this biennial survey is to provide information on trends in the nature and incidence of fraud, both over time and across national borders. It is the longest running and widest ranging global survey conducted by professionals dealing on a daily basis with fraud. There is ample evidence that the impact of fraud on business is large enough to be a major concern, but the secretive nature of fraud precludes any meaningful estimate of the amount of fraud that takes place.

Fraud is not a new thing. The history of business and indeed mankind is littered with misrepresentation for unlawful gain. At Ernst & Young we see the increased emphasis being placed upon the prevention and detection of fraud as part of a healthy process. As the functions of corporate governance workings become more transparent to stakeholders, we hope that fraud will continue to be exposed to the light of day, until the risk of discovery becomes a meaningful deterrent. Sunlight is the best disinfectant.

Fraud risk is higher than ever before. The main contributing factors are the growing complexity of organisations, a history of inattention, understaffing of internal audit functions, the acceptance of some level of fraud as the "cost of doing business", outdated and ineffective internal controls, aggressive accounting practices, and increasingly transient employees. In our experience, more frauds tend to be discovered during recessions.

Complex organisations and transactions create scope for subjective interpretation, borderline disclosure and even misrepresentation. Corporate scandals clearly indicate the potential for abuse and many managers lack the skills and expertise to deal with the associated risks.

With the events following the recent corporate scandals, fraud has been moved firmly onto the agenda of those charged with corporate governance. The public outcry against financial statement fraud and failures in corporate governance sends a clear message. Failure to recognize the issue and deal properly with the consequences can and will be punished by stakeholders.

The internet and the connected economy will continue to impact fraud. Prospective fraudsters have access to more knowledge and opportunities through the internet. Barriers such as national jurisdiction, evidence admissibility and outmoded investigation techniques make electronic crime attractive. At Ernst & Young the use of computer forensics is an indispensable tool and consider its use in nearly every major investigation.

This is our eighth survey and was co-ordinated in 2002 on behalf of the Ernst & Young global fraud network by Mike Savage of the South African practice.

# Key Findings

## Fraud is costly

The true cost of fraud goes beyond the financial loss to the impact on reputation, diversion of management focus, morale and loss of trust within teams.

Financial recoveries appear to be improving over prior years, with half the losses recovered. Unfortunately, less than a quarter is recovered from the perpetrator and the apparent improvement is mainly from insurers.

## Watch the insider

Some 85% of the worst frauds were by insiders on the payroll. This is in line with our experience in previous years.

Over half of the perpetrators were from management, up from a third in previous surveys. Interestingly, while managers had been with the organisation for some time, about half of those managers had spent less than a year in that management position.

## It could happen to you

About half of the organisations that responded had been significantly defrauded in the last year. Fraud was not concentrated in any one geographic region, industry or size of organisation.

As organisations open their systems to e-commerce, they become more vulnerable to the risk of external fraud than ever before.

Despite the electronic nature of most transactions and communications in modern business, electronic evidence was only used in 5% of investigations.

## Prevention is better than cure

For the first time in our survey experience, most organisations now have formal fraud prevention policies. These include codes of corporate governance; employee conduct and fraud response plans. Internal controls, management review and internal audit remain the most useful fraud prevention and detection factors.

We believe that more could and should be done by those charged with corporate governance in fraud prevention and awareness. Generally in response to anti money laundering regulatory pressures, organisations in the financial services industry do seem to be leading the way with training investments. We expect fraud awareness training to grow as a cost-effective investment in preventing and detecting fraud in all organisations.

## Lightning does strike the same spot twice

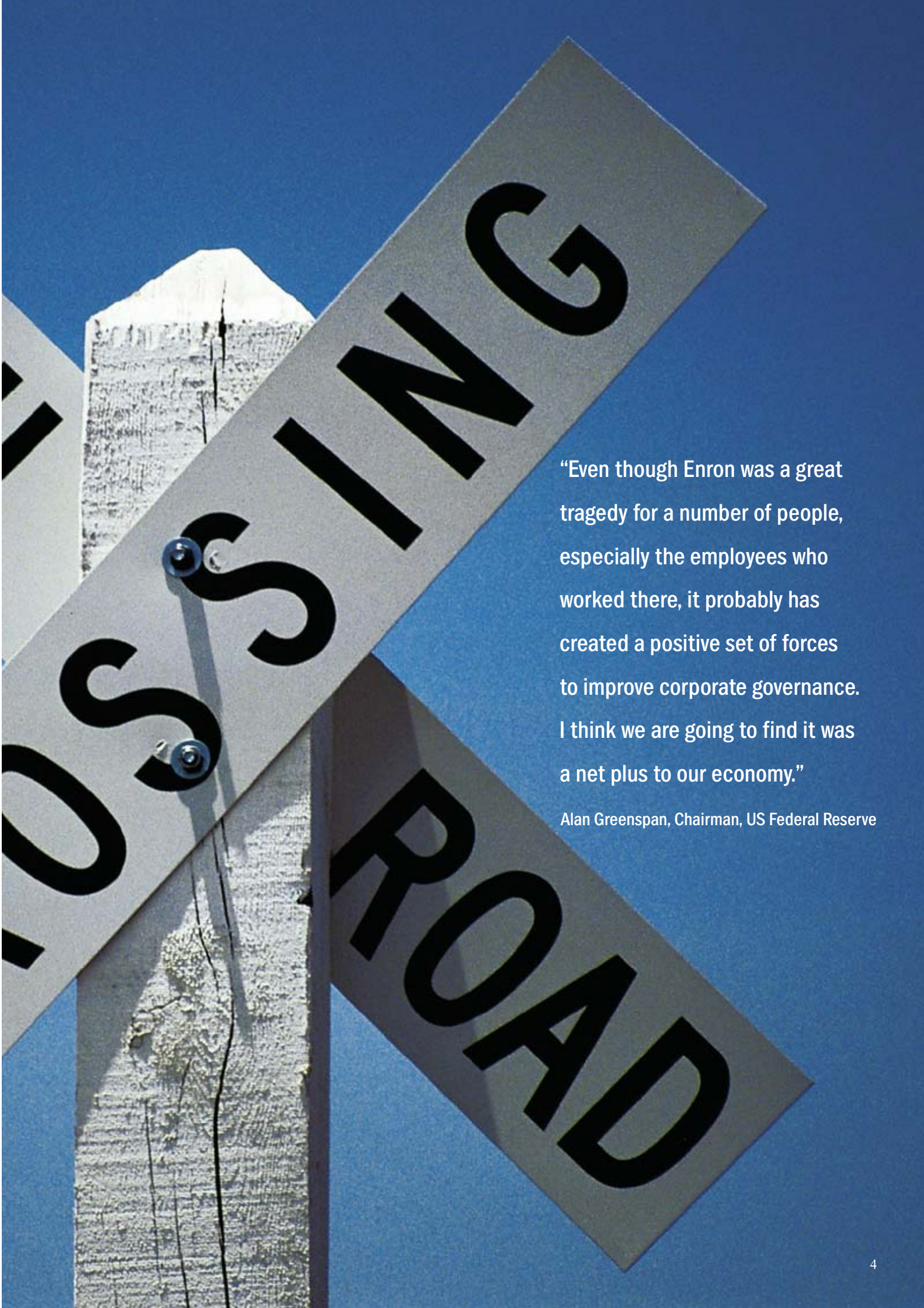
Reasons for investigating a fraud are most likely to include determining the full extent and deterring others. Financial recovery and punishment are also influential factors.

An important part of the reason for determining the full extent is to learn lessons for the future. Typically, organisations fail to deal with the underlying cause or fail to sustain the new internal controls. If lessons are not learned, organisations are likely to be defrauded again and again.

## A job well done

One in five organisations, an increasing proportion, used forensic accountants. Some 88% of those using forensic accountants were satisfied with the service delivered.





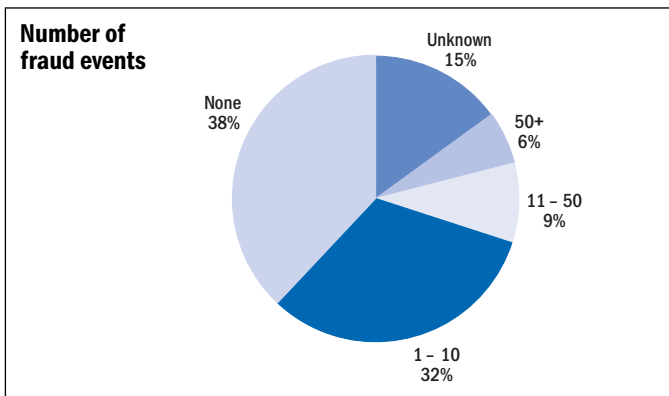
“Even though Enron was a great tragedy for a number of people, especially the employees who worked there, it probably has created a positive set of forces to improve corporate governance. I think we are going to find it was a net plus to our economy.”

Alan Greenspan, Chairman, US Federal Reserve

# General Fraud Experience

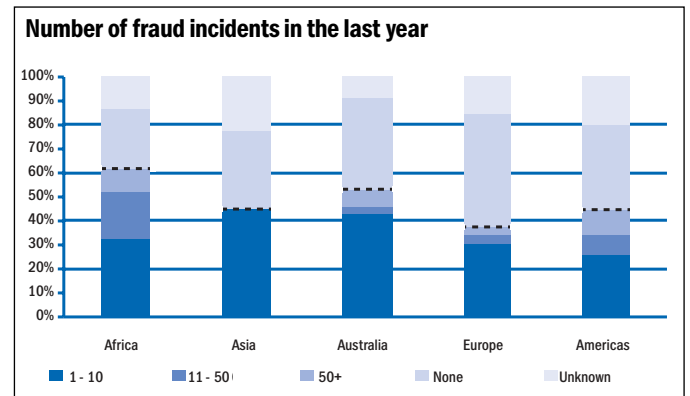
## What's happening?

Fraud is not confined to any particular region, industry or size of business. About half (47%) of the respondents had experienced a significant fraud in the last year.



## Fraud experience by continent

Generally, more frauds were experienced in less developed regions, such as Africa, than in more developed regions, such as Europe.



Keep in mind that the above figures are only the sector 1 frauds that organisations have found and are prepared to admit to.

**Howard Davia in his book 'Fraud 101', states that all fraud cases fall into one of three sectors:**

- “Sector 1 (Exposed & in the public domain) includes all the fraud that has been (or is being) prosecuted (20%).
- Sector 2 (Known by few & not made public) includes all the fraud that victims have discovered, but which has NOT been prosecuted (40%).
- Sector 3 (Undetected) includes all the fraud that has NOT been discovered (40%).”

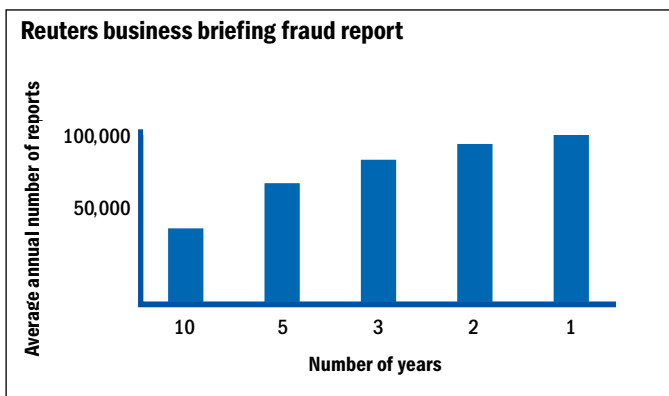
“... It’s symptomatic of a cultural erosion of values prevalent in the business community. And while there are many fine boards, there are far too many boards that operate in a culture of seduction.”

Arthur Levitt, former Chairman, Securities & Exchange Commission  
The Star-Ledger (Newark, NJ, United States), March 31, 2002

### Publicly reported frauds

The number of frauds reported generally in the media is increasing, although at a slower rate than in prior years. We looked at the number of headlines reported by Reuters business briefing over time. While there were nearly 385 000 articles reporting on fraud over the last 10 years, the average annual number of headlines seems to have more than doubled to nearly 90 000 a year.

This is only the tip of the iceberg, as only about 20% of frauds are exposed and in the public domain. Many frauds are either discovered but not made public or have not yet been detected.



### What works?

We asked respondents to rank the factors most likely to prevent fraud or detect fraud. In line with previous years, internal controls remain generally accepted as the best way to prevent and detect fraud. In our experience of investigating fraud, there is more often than not an internal control which should have prevented or detected the fraud - but it was either over-ridden, or not properly understood by the staff responsible for the control.

Management review and internal audit are also seen as useful in preventing and detecting fraud.

Whistleblowers are more accepted as a way of detecting fraud than they were in prior years. This may be attributable to enabling legislation in many countries, which protects whistleblowers and a better public understanding of their role. More organisations are implementing formal channels such as reporting hotlines.

External audit is viewed as a preventative factor, but not generally likely to detect fraud. Most felt that fraud was more likely to be detected by accident than by external auditors.

Factor	Prevention	Detection
Internal controls	1	1
Management review	2	4
Internal audit	3	3
External audit	4	6
Whistle-blowers	5	2
Accident	6	5

### Why investigate?

The main reasons for investigating were to determine the full extent, to deter others and to secure financial recoveries. Some organisations did investigate to punish the perpetrator, but they were a minority.

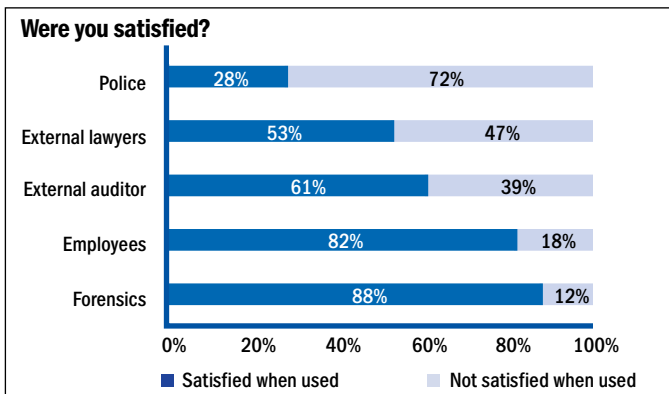
An important part of the reason for determining the full extent is to learn lessons for the future. Frequently the same fraud is perpetrated in the same organisation, either at a different location or at a later time.



“I realize that we have had a lot of smart people looking at this and a lot of accountants including AA&Co. have blessed the accounting treatment. None of that will protect Enron if these transactions are ever disclosed in the bright light of day.”

Sherron Watkins, Enron

### A job well done



Organisations do turn more frequently to employees to do the investigation than any other source. Employees did a third of the investigations. When they do so, nearly four in five reported that they were satisfied with the investigation.

A quarter of the investigations were handed to the police for investigation. Only 28% of those respondents were satisfied with the resultant investigation.

One in five investigations were referred to forensic services. This is much higher than in prior years, reflecting an increasing tendency to draw in specialist and independent skills on complex cases. In total, 88% of these respondents were satisfied with the forensic investigation.

The remainder of the investigations were referred to the external auditor (13%) or external lawyer (10%). In both cases more than half the respondents were satisfied with the investigation.

Some regional highlights are that:

- Employees were used less frequently in Asia and Africa to investigate frauds
- Forensic specialists are used less often in Europe
- External auditors are used more frequently in Asia

“It requires a great deal of boldness to make a great fortune, & when you have it, it requires 10 times as much skill to keep it.”

Ralph Waldo Emerson



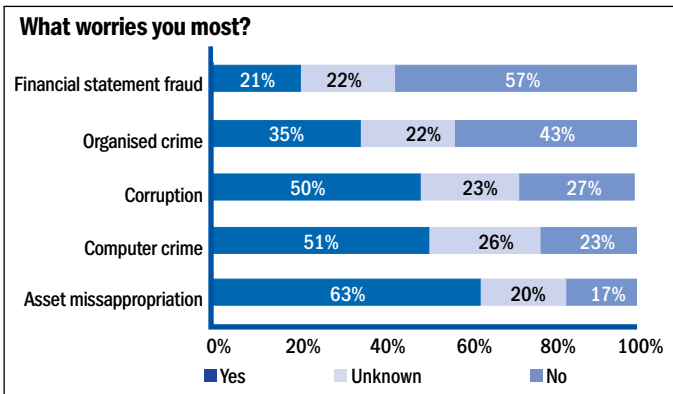
# Fraud Perceptions

## What keeps you awake at night?

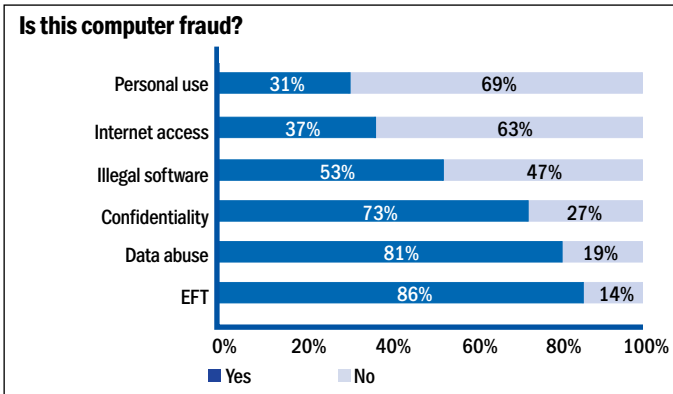
Organisations were significantly more concerned about asset misappropriation than any other type of fraud. About half were concerned about computer crime and corruption and a third were concerned about organised crime.

African and Asian respondents were relatively more concerned about corruption and collusion with organised crime.

In total one in five respondents are worried about financial statement fraud by a reporting unit, for example by manipulating results. This is a big concern given that most respondents were directors or managers commenting on organisations under their control. If they were having sleepless nights on this issue, this would tend to confirm market concerns on the quality of publicly reported earnings. As these concerns materialise, future results might be diluted, even if the effect is not so material as to require restatement of previously published results.



## Computer Fraud



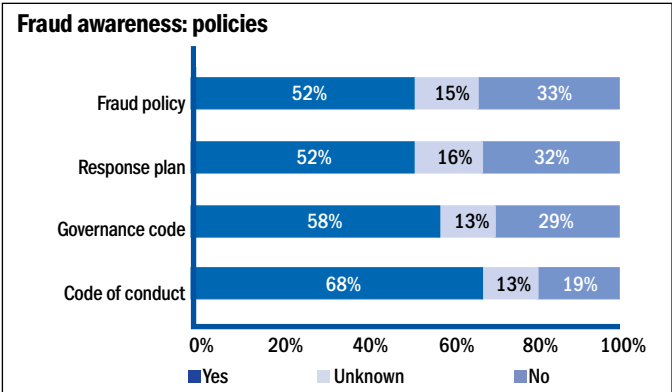
Only a third of respondents felt personal use of hardware or software or of Internet facilities amounted to fraud. The view seems similar to condoning the use of other company facilities, such as telephones.

Only half of the respondents considered the use of illicit or unauthorized software to be fraud. Generally, Asian respondents were less likely to view illegal software as computer fraud.



# Fraud Awareness

## Policies



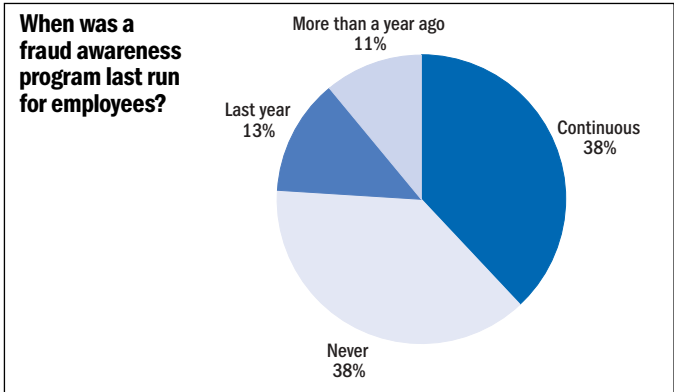
For the first time since we started our survey, respondents indicated that over half the organisations had codified guidelines on dealing with ethical and fraud related behaviours, such as codes of conduct, governance codes, response plans and anti-fraud policies. This is an encouraging move in the right direction, as two years ago only a third had such policies in place.

Interestingly, corporate governance statements were less common in European respondents than other continents and fraud response plans were less frequent in Asia.

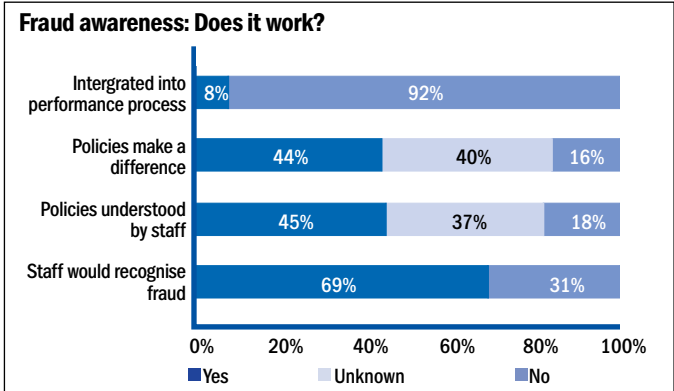
**Ernst & Young offers a practical guideline on contingency plans for dealing with fraud. For a copy, please contact the country fraud contact listed at the end of the survey.**

## Implementation

However, we are concerned that issuing a policy by itself is insufficient. People need to be educated and held accountable to these guidelines or their behaviours are unlikely to change. Enron had both a code of ethics and a whistleblower mechanism – neither worked in time.



Organisations are putting more effort into training their staff in the use of these policies. Over 60% had trained staff and over half had done so within the last year. This is a significant shift from our last survey given that only 30% reported that they had trained staff. We remain of the view that more could and should be done.



For example, 92% did not integrate responsibility for these policies into performance agreements. Less than half felt that the policies made a difference or that staff understood them.

“The development of a corporate anti-fraud culture requires serious and sustained training. Yet little progress in the marketplace can be reported since the Panel’s 1999 survey which revealed serious deficiencies in the programmes run by business, educational institutions and the professions.”

Institute of Chartered Accountants in England & Wales – ‘Fraud Advisory Panel’ 2001 annual report



Twenty per cent of North Americans surveyed telephonically say they are personally aware of people stealing from their employers, according to a poll conducted for professional services firm Ernst & Young LLP.

The types of fraud identified as major problems include inflating expense accounts, “cooking the books,” and pocketing money from cash sales.

(TORONTO, August 8, 2002)

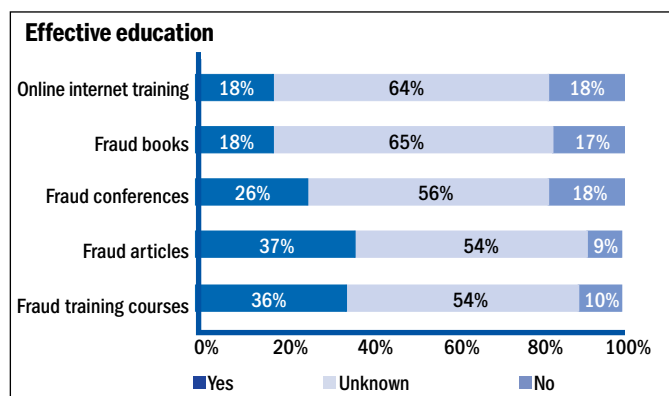
### Staff

Somewhat disturbingly, a third of the respondents felt that staff would not recognise fraudulent transactions. This indicates that there is still much work to be done to make organisations fraud resistant. Fraud awareness levels can be raised significantly with low cost training interventions.

Employees seem to have a different perspective, stating that they are in fact often personally aware of people stealing from their employers. In a recent Ernst & Young North American survey, one in five employees stated that they were personally aware of people stealing from their employers. Perhaps fraud reporting channels could close the gap between the perceptions of staff and management, as 80% of respondents said that they would be likely to report fraud.

Another way of looking at this employee response is that if you have more than five employees, you were probably the victim of fraud last year.

### Education



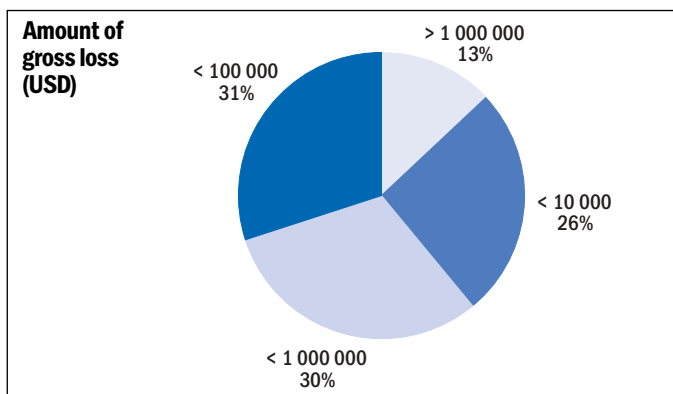
A large proportion of organisations were unsure as to the most effective channel for education about fraud, possibly reflecting on the quality of educational material available. Generally, training courses and articles were perceived to be more effective than conferences, books and Internet training. Australasian respondents showed significant faith in conferences and articles as an educational channel.

# Specific Fraud

We asked respondents to share information about the worst frauds they had suffered over the last year.

## Size of loss

More than half of the losses were relatively small in value, at less than USD100 000. Of concern though is that 13% of the worst losses were over one million US dollars in amount. These losses are large enough to have a serious impact on the profitability or even survival of the organisation, particularly given the poor prospects of meaningful recoveries.



## Recoveries

The true cost of fraud extends beyond the financial loss to the impact on reputation, management time, morale and loss of trust within teams.

Organisations are recovering a greater proportion of their financial losses than in previous years. The amount recovered has grown from 29% to 51%.

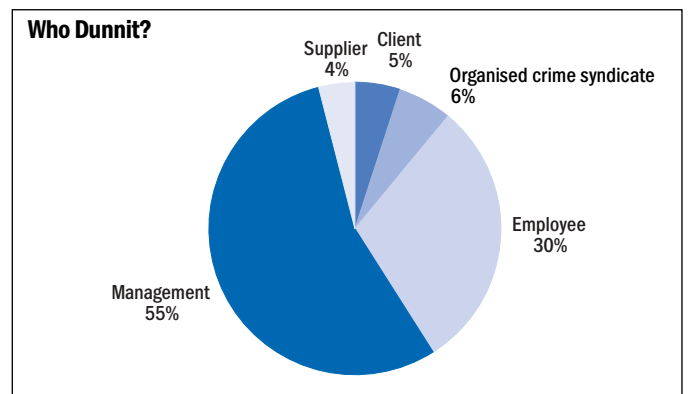
While recoveries from the perpetrator remain low (at about 20%), more is being recovered from insurers, banks and suppliers than before.

	Insurer	Perpetrator	Not recovered	Other (mainly banks & suppliers)	Total
Current survey	19%	22%	49%	10%	100%
Prior survey	7%	20%	71%	2%	100%

We do not know what is driving these recoveries. It may be that governance codes, risk management and concerns on director liability may be driving more businesses to insure against dishonesty.

Similarly, we speculate that organisations may be viewing their banks less as trusted business partners and more as counter parties. Additionally, anti money-laundering legislation now sets clearer guidelines for negligence by banks.

## Who was the offender?



Some 85% of the fraudsters were on the payroll, with 55% coming from the ranks of management. This correlates closely with our 2000 survey, in which 82% of fraudsters were on the payroll, but only one third were management.

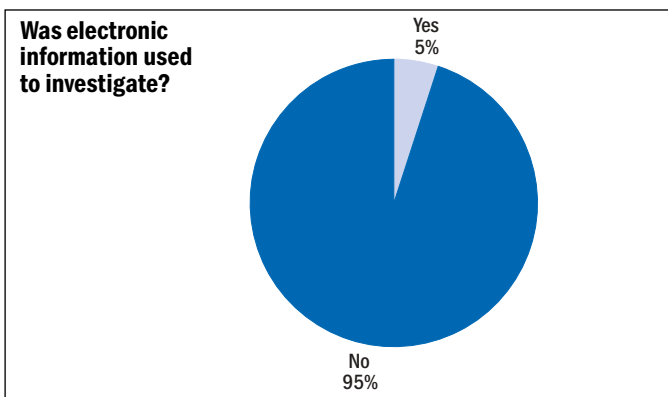
It pays to watch new management closely. Some 85% of the managers committing the largest frauds had less than one year's service in that post.



**“It’s like going to a buffet and stuffing your pockets with everything in sight.”**

Charles Elson, corporate governance specialist,  
University of Delaware

### Special tools



In today’s connected economy, transactions and communications are more often electronic in origin than paper based.

It is surprising that investigations are not yet focused on securing the electronic evidence such as disk drive images, e-mails and access logs. It may be that the value of electronic evidence was limited because regulations over the admissibility of that evidence have lagged, or that investigation competencies have not yet moved to match this new source of evidence.

At Ernst & Young, we consider the use of computer forensics on nearly every investigation because it is fast, complete and effective. It has great value as an investigative tool and we are surprised that electronic evidence was only used in 5% of the investigations.

**“Certified Fraud Examiners estimate that six percent of revenues will be lost in 2002 as a result of occupational fraud and abuse.”**

Association of Certified Fraud Examiners ‘2002 Report to the Nation on occupational fraud and abuse’



# Section 6

## Survey Demographics

Questionnaires were sent out to directors and managers in major organisations across the globe. Their responses were compiled and analysed to produce the survey.

Continent	%
Africa	33
Australasia	19
Europe	37
Americas	11
Total	100

Business sector	%
Energy, Chemicals and Utilities	6
Financial services	35
Health	4
Industrial products	8
Government	7
Retail and Consumer Products	14
Technology, Communications and Entertainment	8
Other	18
Total	100

Country	City	Contact	Telephone No.	Email
Aruba	Oranjestad	Yvonne Escalona	+297-8 24050	yvonne.escalona@an.eyi.com
Australia	Melbourne	Terry Richards	+61-3-9288-8000	terry.richards@ernstyoung.com.au
Belgium	Ghent	Bart De Bie	+32-9-243 8064	bart.debie@ey.be
Bermuda	Hamilton	John McKenna	+1-441-295 7000	John.McKenna@eybm
Brazil	São Paulo	Charles Holland	+55-11-821 5200	charles.holland@br.eyi.com
Canada	Toronto	Nick Hodson	+1-416-864 1234	nick.hodson@ca.eyi.com
Caribbean	Port of Spain	Barry Davis	+1-868-622 0175	barry.davis@tt.eyi.com
Cayman Islands	Grand Cayman	Jonathan Kahlberg	+1 345 946 0081	jonathan.kahlberg@ky.eyi.com
Chile	Santiago	Antonio Aldunate U.	+56-26-39 1454	antonio.aldunate@cl.eyi.com
Czech Rep	Prague	Milan Slavik	+420-2-2207 2192	Milan.Slavik@ey.cz
Denmark	Copenhagen	Kim Gundelach	+45-35-82 4810308	Kim.Gundelach@ey.dk
France	Paris	Francois Santin	+33-1-46936822	francois_santin@ernst-young.fr
Germany	Hamburg	Klaus Fischer	+49 40 36132-11 558	klaus.fischer@ernst-young.de
Greece	Piraeus	John Evangelou	+30-210-288 6172	john.evangelou@gr.eyi.com
Hong Kong	Hong Kong	Clive Saunderson	+852-2956 1188	clive.saunderson@hk.eyi.com
Hungary	Budapest	Tamas Szabo	+36-1-252-8333	tamas.szabo@eu.eyi.com
India	New Delhi	Kali Prasad	+91-11 699 2931	kali.prasad@in.eyi.com
Indonesia	Jakarta	Cliff Sanderson	+62 21 515 1960	cliff.sanderson@id.eyi.com
Ireland	Dublin	Cyril Maybury	+353-1-475 0555	cyril.maybury@ie.eyi.com
Italy	Milan	Gabriele Boleso	+39-02-87 90 89 02	gabriele.boleso@it.eyi.com
Japan	Tokyo	Hideo Takahashi	+81-3-3503 1191	takahashi_hd@hc.oscaudit.or.jp
Jersey	St Helier	Richard Powell	+ 44 1534 288639	rpowell@ernstj.co.uk
Kenya	Nairobi	Coutts A Otolo	+254-2 727640	Coutts.A.Otolo@eyi.com
Malaysia	Kuala Lumpur	Tony Foo	+60-3-244 2333	tfoo@seccom.com.my
Malta	Sliema	Mario Galea	+356 2134 2134	Mario.PGalea@mt.eyi.com
Mexico	Mexico City	Francisco Alvarez	+525-283 1354	Francisco.Alvarez@eyi.com
Middle East	Bahrain	John M Mower	+973-535 455	John.Mower@bh.eyi.com
Netherlands	The Hague	Peter Schimmel	+31 70 441 21 20	peter.schimmel@ey.nl
New Zealand	Auckland	Ben Palmer	+64-9-377 4790	ben.palmer@nz.eyi.com
Norway	Oslo	Rolf Sæther	+47-22-03 6349	rolf.k.saether@ey.no
Nordic	Stockholm	Kenneth Johansson	+46-8-520-595 41	kenneth.johansson@ey.se
Pakistan	Karachi	Ahmed Patel	+92-21 241 5582	frrm@cyber.net.pk
Peru	Lima	Jorge Perez	+51-1-411 4444	jorge.perez@pe.eyi.com
Romania	Bucharest	Garry Collins	+40-21-410 44 49	Garry.R.Collins@ro.eyi.com
Russia	Moscow	Mark Maurer	+7-095 705 9292	
Singapore	Singapore	Daryl Kennedy	+65-6428-7043	daryl.kennedy@sg.eyi.com
South Africa	Johannesburg	Mike Savage	+27 11-772-3000	savagmi@ey.co.za
Spain	Madrid	Jose Luis Solis Céspedes	+34-91 5727617	jsolisce@eyoung.es
Switzerland	Zurich	Rolf Schatzmann	+41-58-286 3111	rolf.schatzmann@eycom.ch
Turkey	Istanbul	Okan Aydingun	+ 90 212 315 30 00	okan.aydingun@tr.eyi.com
UK	London	David Sherwin	+44-20-7951 3564	dsherwin@uk.ey.com
United States	Chicago	Michael Emmert	+1-312-879 3323	michael.emmert@ey.com
United States	Cleveland	Stephen Seliskar	+1-216583 8120	stephen.seliskar@ey.com
United States	Houston	Sheri Toivonen	+1-713-750 8421	sheri.toivonen@ey.com
Zimbabwe	Harare	Robert McIndoe	+263-4 75 1856	robert.mcindoe@ey.co.zw

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