European fraud survey 2009

Is integrity a casualty of the downturn?

Ernst & Young
Quality In Everything We Do

Contents

Foreword

As the economic downturn persists, management face tougher challenges than ever before. Amid this turmoil, the ever-present threat of fraud grows stronger. High profile frauds have surfaced in a number of major markets, as the rapidity of the downturn has denied fraudsters the liquidity and markets necessary to cover their tracks.

New risks will emerge too, as the severity, volatility, and pace of change foster opportunities and incentives for fraud. In these difficult times, one would expect management to be focused on stabilizing their businesses and protecting corporate assets.

In 2006, Ernst & Young initiated a series of surveys of a broad range of employees at European companies that measure the perception of fraud risks and how management and board members are responding to the challenges. The *2009 European fraud survey* reflects the views of over 2,200 respondents — from the shop floor to the boardroom — in 22 countries. It contrasts the views of Western Europe with Central and Eastern Europe and highlights a number of important themes, including the perceived depth of commitment of management to fraud risk mitigation and what employees expect from the regulators of their companies.

The findings are startling.

There is a disappointing tolerance of unethical behavior. Making cash payments to win business, and even deliberately misstating financial performance in an effort to mask disappointing results, were supported by alarmingly large numbers of respondents.

Respondents question the integrity of their own senior management and board members with many believing them to be untrustworthy. They emphatically call for directors to be held accountable for lapses that allow corporate fraud to take place.

As a result of this mistrust of management, our research suggests that employees expect regulators to do more to protect them from wayward management and to ensure their business leaders are compelled to intensify their efforts to protect companies from fraud.

The good news is that the current period of adversity can present opportunities to drive change more rapidly and effectively than in more prosperous times. Now is the time for management to act urgently and emphatically and a chance to restore ethical behavior. Careful budget prioritization in relation to internal audit and compliance resources and demonstrating a willingness to conduct robust investigations are but two examples of how this might be achieved. For listed companies, broadening their non-financial reporting to include comments on their anti-fraud and anti-corruption efforts is worthy of consideration. Anti-fraud is key to good corporate social responsibility.

Benefits from action now will be long lasting. Reputational damage from aberrational behavior can be minimized with quick, clear communication of the issue and decisive remedial efforts. Assets will be better safeguarded as a result. When growth returns, the company will be better positioned to deter schemes from taking hold. Demonstrating a commitment to ethical business — now and in the years ahead — is a critical business imperative.

This survey was conducted in 2009 on behalf of Ernst & Young's Fraud Investigation & Dispute Services practice. We would like to acknowledge and thank all respondents for their time and insights.

David L. Stulb

Global and EMEIA Leader
Fraud Investigation & Dispute Services

Executive summary

Allegations of significant fraud are on the increase as the global financial crisis has taken hold. Today's adverse conditions are making certain frauds harder to conceal as the economic growth in established and emerging markets slows rapidly.

In addition, the incentive to defraud is strengthening in order to maintain income and reported earnings. In the current climate, management are under incredible pressure to stabilize their businesses and meet financial targets — both at a personal and organizational level. However, it is management who must take the lead in responding to the threat of fraud and corruption, and set the tone for all employees to follow.

Respondents in our survey suggest, far from meeting the challenge, management are in fact part of the problem. The respondents overwhelmingly question the integrity of their leaders — and perhaps with good cause. Our survey reveals that many employees would accept fraud and corruption in the work place in order to survive the current economic storm and indeed senior management are even more likely than rank and file to condone activities such as cash bribes and financial statement fraud.

These beliefs are at the heart of fraud trends perceived by our survey respondents. They tell us the current economy will engender more fraud, and the impact of continued industry consolidation will exacerbate the threat. We learn that too few companies are increasing their efforts to meet these challenges and it is to the regulators that employees now turn for help in keeping their leaders on the path to ethical conduct. A closer study of these trends reveals some of the underlying causes for these intensely held views.

The current economic climate and fraud

Our survey respondents believe the likelihood of fraud and corruption is set to rise further still.

- 55% of the respondents expect corporate fraud to increase over the next few years.

Corporate responses to the downturn can create new opportunities for fraudsters if staff redundancies open gaps in financial controls.

- 36% of our respondents believe that normal policies and procedures are likely to be overlooked as staff redundancies are made.

The trend of consolidation during an economic downturn can also disrupt ongoing efforts by corporates to prevent fraud.

- Almost half of our respondents believe that the differing standards of behavior that are typically held by two merging companies poses a major challenge to anti-fraud efforts.

Companies' readiness to meet the rising challenge

Despite the increasing risk of fraud in the current environment, many companies have not responded with a corresponding level of increased vigilance. Respondents appear to see combating fraud as someone else's responsibility and place heavy reliance on internal and external audit to prevent and detect fraudulent activities.

- Two out of five respondents believed that their company's anti-fraud efforts had not increased in the last few years.

Furthermore, they severely doubt management's integrity and perceive that their leaders pose significant risks.

- 29% of our survey respondents believe management to be untrustworthy.
- 42% of respondents believe that the senior ranks in an organization pose the biggest threat of fraud.

Alarming tolerance for unethical behavior

The tolerance of unethical behavior appears to be an unwelcome side effect of the pressure that employees are under.

- When asked whether they considered various types of unethical behavior to be acceptable to help a business get through the downturn 47% thought that one or more types of unethical behavior was acceptable.
- 25% of our respondents thought it was acceptable to make cash payments to win new business.
- 13% of senior managers and board members polled told us that misstating financial performance was justifiable in today's economic climate.

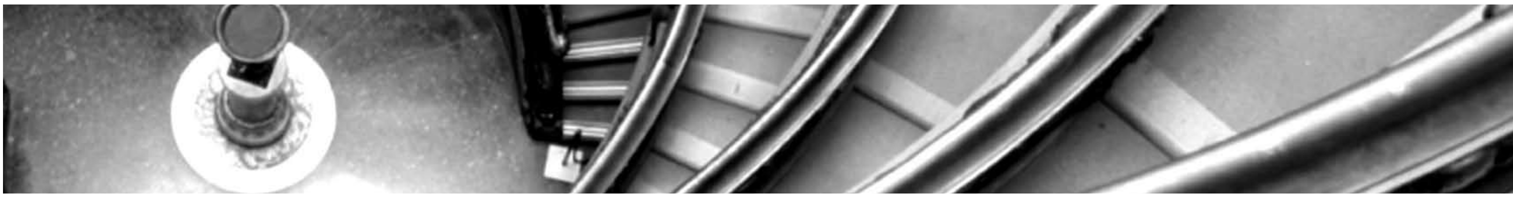
Employees look to the regulators for help

Given their concerns about the integrity of management and the rising risk of fraud, our survey respondents call for increased and more effective regulation. Our research suggests that there is support in the workforce for better enforcement of measures designed to prevent fraud and corruption, and little tolerance of management failure.

- 54% of our respondents said a less stringent approach to corporate fraud by regulators would not be appropriate.
- The need for more decisive action by government to combat fraud was recognized by two-thirds of our respondents.
- 70% of respondents believe that directors should be held personally liable for frauds that occur under their watch.

The message is clear: the response of companies to fraud in the current economic crisis is under the spotlight. The general public, employees, regulators and other stakeholders will want to see senior management — and in particular the board — taking the lead in evaluating the company's anti-fraud activities. Directors and management must be prepared and decisive in their response when instances of fraud occur. Only through taking such measures will directors and management be able to minimize their own liability and deter future fraudulent activity.

Troubled times



Companies are weathering one of the most challenging business environments in history. A storm that started in the financial sector has taken hold across other sectors in economies worldwide, taking many well-known brands and businesses into insolvency.

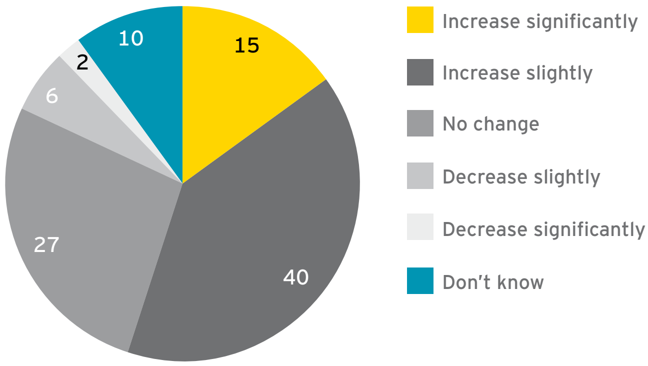
The current state of the market has had an impact on all areas of corporate financial performance. Balance sheets have been decimated as assets have been written down to reflect the lower values that can be attributed; underlying profitability has declined with reduced consumer demand and spending, and cash flows have been squeezed as traditional financing has become harder to obtain.

This has, for many companies, become a time when survival rather than growth is the primary focus.

It is in this context that this year's *European fraud survey* was undertaken, and the issues it raises demonstrate that now, more than ever, fraud should be high on the agenda of boards and senior management.

This view is supported by our survey: over half of our respondents (55%) expect to see corporate fraud increase in the next few years.

Corporate fraud is expected to increase



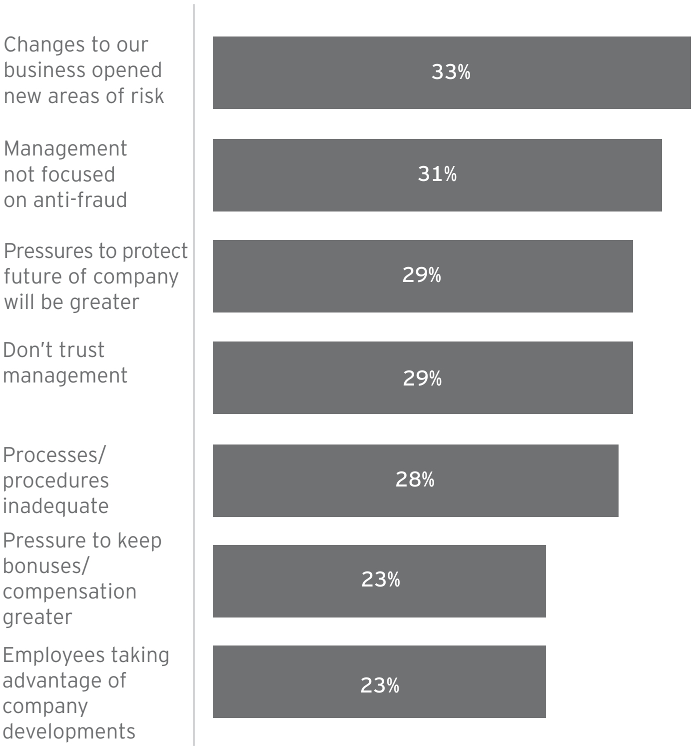
Q Do you expect corporate fraud to increase or decrease in the next few years?
Base: all respondents (2,246)

	Increase
	%
Western Europe	54
Central and Eastern Europe	55
Greece	76
Hungary	68
Ukraine	67
Turkey	67
Russia	65
Spain	64
UK	63
Norway	60
Ireland	59
Germany	58
Total	55
Italy	53
Sweden	53
Switzerland	53
Belgium	51
Poland	50
Luxembourg	49
Romania	48
France	47
Austria	40
Czech Republic	40
Slovakia	38
Netherlands	31

It has frequently been noted that the level of observed fraud increases during times of recession. This is often put down to fraudsters having less "padding" with which to conceal their improper activities without taking greater risks. An acute example of this has been the number of publicly reported "Ponzi" or "pyramid" fraud schemes that have come to light. These schemes, in which early investors are paid with the money put in by subsequent investors, are by design reliant on growth and on fresh capital to perpetuate the fraud and have been quick to collapse as liquidity and investable assets have evaporated from the market place.

However, our survey provides evidence that the current environment increases the incentive and personal justification for employees to commit fraud. In total, 52% of respondents who felt that their company was at increased risk of fraud cited either pressure to protect the company results (29%) or keeping personal bonuses (23%) as the underlying cause. When coupled with our finding that respondents are alarmingly tolerant of inappropriate behavior to get through the current downturn, we no longer face a theoretical increased risk of fraud but a likely risk.

A range of factors are increasing the risk of fraud



Q You agreed your company will be at increased risk of fraud over the next few years. Why did you say that?
Percentages can total more than 100% as respondents can choose multiple answers.
Base: all those agreeing their company will be at increased risk (486)

	Western Europe	Central and Eastern Europe
	%	%
Changes to business	36	28
Management not focused on anti-fraud	25	39
Pressures to protect future of company	33	24
Don't trust management	26	33

Our survey indicates that 33% of those who are anticipating greater fraud risk believe it will result from changes that will be made to businesses in response to the downturn. In a world of falling demand and prices, companies face tough choices to maintain their profitability. Cost-cutting measures, including large scale redundancies are being made. Other distressed companies are being viewed by acquisitive eyes, on the look out for a bargain. Given that personnel roles and responsibilities are affected by such developments, both of these scenarios increase the opportunities for individuals to commit fraud as weaknesses emerge in the control environment.

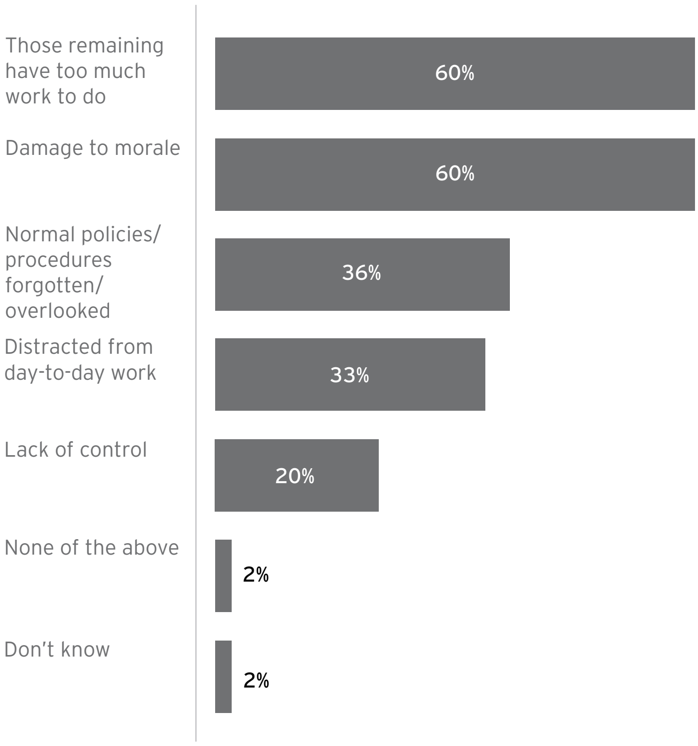
With such changes occurring in the landscape, it is not surprising that 31% of those surveyed believed that management will take their eye off the ball and reduce their focus on anti-fraud.
Most alarmingly for businesses, though, is the view of 29% of respondents that management are untrustworthy. The very people who have the greatest ability to set the tone of their organizations by demonstrating through their leadership and behavior what is considered acceptable do not seem to be responding well to current pressures in the view of respondents.

The hidden costs of redundancy

As European unemployment has reached record levels, companies of all sectors, sizes and geographical markets are announcing redundancies on a near-daily basis. In addition to the inevitable devastating impact on the personnel who lose their jobs, our survey shows that those employees left behind also expect to be adversely affected.

When we asked about the most significant problems that result from redundancies, the leading two responses were having too much work to do and the damage to morale.

Redundancies impact fraud risks



Q Which of the following do you see as being most significant problems when companies make redundancies?
Percentages can total more than 100% as respondents can choose multiple answers.
Base: all respondents (2,246)

	Western Europe	Central and Eastern Europe
	%	%
Those remaining have too much work to do	60	62
Damage to morale	65	51
Normal policies/procedures forgotten/overlooked	36	37
Distracted from day-to-day work	33	33
Lack of control	20	21

Respondents' views were largely consistent across Europe. However, those surveyed in Western Europe were more likely to see damage to morale as a significant problem than those in Central and Eastern Europe. The damage to morale caused by redundancies can pose a significant fraud risk. Employees suffering low morale may be less inclined to properly carry out their roles and responsibilities, providing the opportunities for others to commit fraud. With lower morale employees may find it easier to rationalize inappropriate behavior, including fraudulent acts, or may simply be less inclined to report inappropriate behavior of others.

Around a third of respondents (36%) mentioned that normal policies are likely to be forgotten or overlooked during cycles of redundancies. In our experience this poses a real danger for corporate anti-fraud efforts. Look at an organization chart, and redundancies or reorganizations can appear to leave current policies and procedures intact. But they often overstretch the back office, leaving fewer people to monitor and implement procurement decisions or payment authorizations.

At the same time, reorganization can leave responsibility for the execution of anti-fraud policies with inexperienced managers who may have trouble spotting anomalies or deciding what is reasonable. The danger is magnified because internal sources of help are likely to have smaller budgets, too. With less money for anti-fraud training, or for surprise visits or travel to remote offices, internal audit teams will be less able to compensate for cuts elsewhere.

The question remains as to what the appropriate business response to these risks should be in an environment when budgets are constrained.

Senior management should ensure sufficient time is allowed for handover. New heads of business should ensure that they have access to resources with a range of skills, such as process understanding, accounting expertise, document review, interviews, data analytics and field studies and the ability to report independently and outside of existing hierarchies.

To protect a company's assets when restructuring, senior management should also recognise the significant incentives and opportunities for aggrieved redundant staff to steal invaluable Intellectual Property ("IP") on leaving. Leavers should be reminded of the company's policy regarding IP prior to their departure, and consideration should be given to monitoring instances of electronic access to valuable data which could be indicative of potential IP theft.

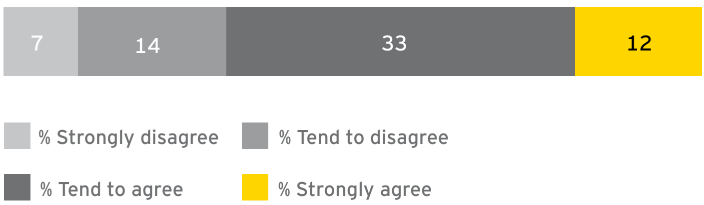
Audit committees should ensure their plans are prioritized to the risks which really matter, that they can explain to the board how coverage of the audit plan is adequate, what indicators have led to a certain focus and that the approach has been validated.

Acquiring assets, acquiring risks

The current downturn is likely to result in consolidation in many sectors. While such takeovers can bring a degree of financial stability to the acquired entity, the requirements of mergers and acquisitions work can often distract managers at all levels from their usual roles.

Almost half of our respondents (45%) agreed that the opportunities for an individual to commit fraud are likely to increase in a merger or takeover situation.

Fraud risk rises during industry consolidation

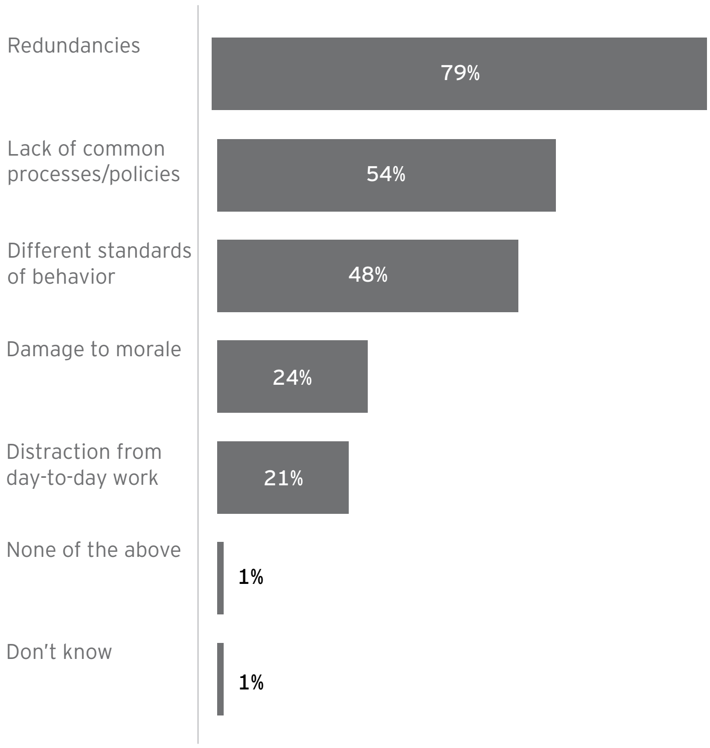


Q To what extent do you agree or disagree that during a merger/takeover situation the opportunities for individuals to commit fraud are likely to increase?
Percentages total less than 100% as "don't know" answers have been excluded.
Base: all respondents (2,246)

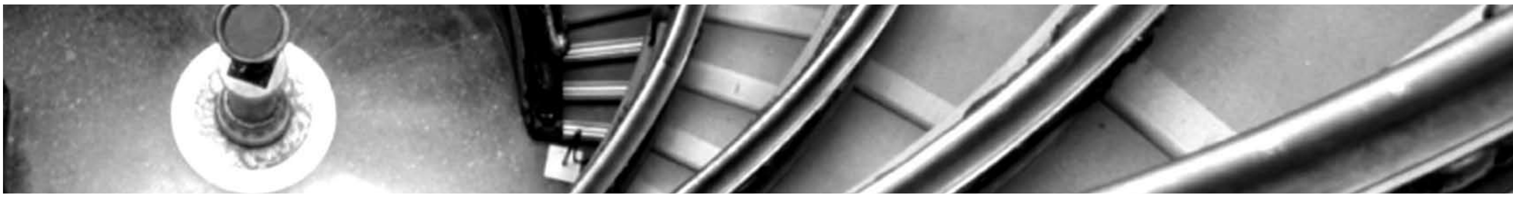
	Strongly agree
	%
Western Europe	9
Central and Eastern Europe	17

There were significant variations in responses between countries, with Greece (56%), Italy (50%) and Spain (49%) in Western Europe, and Russia (69%), Czech Republic (65%) and Poland (57%) in Central and Eastern Europe being most likely to agree with the hypothesis.

Effects of a merger combine to increase fraud risk



Q Which of the following do you see being the most significant problem when two companies are brought together?
Percentages can total more than 100% as respondents can choose multiple answers.
Base: all respondents (2,246)



	Western Europe	Central and Eastern Europe
	%	%
Redundancies	82	75
Lack of common processes/policies	56	49
Different standards of behavior	47	50
Damage to morale	28	19
Distraction from day-to-day work	18	27

Our respondents were also asked to consider the factors that may give rise to these risks. In addition to the increased opportunities for fraud resulting from redundancies, a lack of common processes and policies is likely to create new gaps in procedures that can be exploited by the unscrupulous. And for those companies that have invested in and taken fraud risk seriously, different standards of behavior can undermine years of training.

In our experience, the factor identified by only one in five of our respondents — distraction from day-to-day work — poses a real threat. This, when coupled with the anticipated loss of internal control, leaves the door wide open to fraudulent activity.

Effective fraud management is reliant on the consistent application of recognized procedures. More distraction means less vigilance, and less vigilance means more opportunities to commit fraud. While the process looks unchanged on paper, part of what used to be overseen is now overlooked.

A case for forensic due diligence?

Almost half of our respondents believe that differing standards of behavior represent a significant problem arising as a result of mergers. When a business is acquired, the purchaser will be taking on the fraud and compliance risks arising as a result of such behavioral differences.

Corrupt activities within an acquired business can pose a significant risk for purchasers. The acquirer could be paying for revenue streams dependent on corrupt conduct. Indeed, in the worst case, the purchasing company can become liable for pre-acquisition corrupt activities undertaken by the newly acquired company.

How can you be sure that your acquisition target does not obtain its business through the use of bribes or other corrupt activities? With increasing legislation and enforcement targeting corruption in countries throughout the world, any company looking to acquire or sell a business with overseas interests must be aware of the applicable anti-corruption statutes.

Companies should explicitly consider whether forensic due diligence, including specific anti-corruption related procedures, would be prudent both pre- and post-acquisition.

Acquisition target red flags

An acquisition target with any of the following characteristics may be particularly vulnerable:

- Subsidiaries and operations in emerging markets or countries considered to have high levels of corruption.
- Organizations with public sector contracts.
- Use of consultancy services, especially in the sales function.
- Poorly documented sales commission contingent on contracts being awarded.
- Excessive travel, gift or entertainment expenditure.
- Industries with a history of issues, such as construction and real estate, aerospace, defence and pharmaceuticals.

Closing the gaps created by merger activity involves assessing the anti-fraud programs and business culture of both the acquirer and target. Policies and procedures that reinforce ethical conduct should be harmonized and imposed as quickly as possible and underpinned through employee training. A uniform code of conduct is an important part of demonstrating the company's commitment to ethical business, as is the willingness to investigate any allegations of wrongdoing robustly and to take disciplinary action as needed.

All agents and other third parties associated with a target company in the past who are expected to continue to work for a target company post-closing, should be required to attend training and to amend existing contracts to incorporate appropriate anti-corruption provisions and rights of audit clauses. The audit rights should not be a mere cosmetic addition to such contracts; they should be enforced on a periodic basis to identify and address any significant issues and to demonstrate management's robust approach.

New data, new risks

Lack of common processes and procedures was recognized by 54% of respondents as being a significant problem expected from industry consolidation.

Post-merger, the new organization is often challenged with the need to be able to gather, analyze, and report on data flowing from multiple, incompatible, disparate and complex systems. At a strategic level, there is a requirement to ensure reporting systems can provide information at a consolidated level that relies on the availability and integrity of data in merged and stand-alone operational systems. For example, remote access possibilities or administrator accounts, which could have been installed by current or ex-employees (i.e., made redundant or disgruntled IT staff) provide potential avenues for information leakage and fraudulent manipulation.

Most organizations struggle to meet these challenges because of:

- Lack of understanding of the complexities related to new systems and the requirements of systems integration that can result in security holes that can be compromised.
- Incompatible systems across many different divisions or entities.
- Geographical spread of entities.
- Systemic data quality issues because of inconsistencies that result from different formats, structures, and storage methods.
- Lack of common reporting tools.
- Lack of resource availability to focus on pre-emptively detecting and preventing fraud and abuse as a result of the merger.

All these factors lead to increased post-merger fraud risk.

A climate of write-downs

After companies have been acquired and integrated, further potential pitfalls remain.

Asset write-downs relating to purchased entities have become increasingly common. Company management and auditors should remain vigilant to the fraud risks arising from these, as they can provide a smokescreen where frauds could potentially be hidden.

In recessions, stakeholders are less incredulous and more accepting of bad news — and this creates an opportunity for impairment reviews to go too far. Impairment reviews can be highly subjective, and the assumptions underpinning write-downs may be too harsh, deliberately. It is not unheard of for management to be tempted to load the bad news, with future periods reaping the benefit. This can be especially enticing for new management who might claim to have merely inherited the current woes, and take the credit for the apparent upturn in fortunes in later years' results. Setting up an excessive provision provides a similar opportunity — it allows for a steady release of that provision against future costs, positively impacting future earning results.

Particularly high levels of asset write-downs are being seen across the banking and investment management sectors, which had become used to ever-increasing asset prices. These developments represent a fundamental change to the way in which these businesses have operated. It came as no surprise then that 50% of our respondents from the banking sector who believed that their companies faced increased fraud risk, cited the changes to their underlying businesses as the cause. By contrast, only 9% of comparable respondents from industrial, manufacturing and defence companies recognized such business changes as increasing their risk.

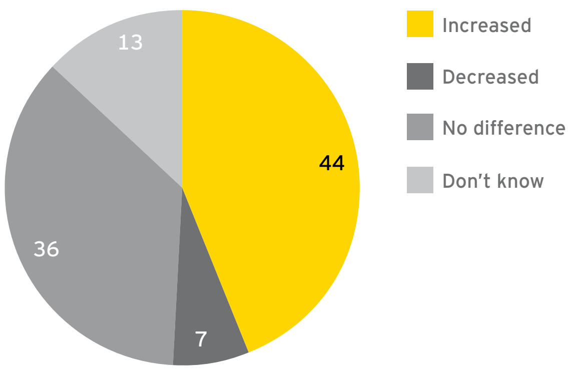
Non-executive board members, internal audit teams and other stakeholders with an oversight or governance role, should pay particular attention to both the approach to the valuation of assets, and the assumptions that underpin it. Particular focus should be given to areas requiring judgement. Subjective areas will exist for most assets, and external help may be required to unravel complex financial instruments or positions and challenge management valuations. This task will be made easier if reviews are planned regularly throughout the year rather than storing them up for the year-end.

Taking your eye off the ball

The many business changes occurring within companies responding to the broader economic environment mean that now is a particularly dangerous time to lose focus on fraud.

Yet, despite increased risk, our survey found that over two-fifths of respondents believed that their company's anti-fraud efforts had not increased in the last few years.

Change to company effort in combating fraud



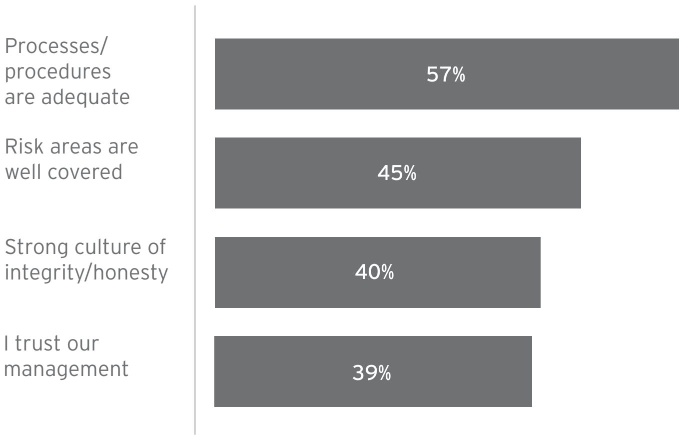
Q Would you say your company's efforts to combat fraud have increased or decreased over the last few years?
Base: all respondents (2,246)

	Increase
	%
Western Europe	43
Central and Eastern Europe	45
Slovakia	58
Ireland	57
Romania	53
Switzerland	51
Greece	50
France	50
UK	50
Luxembourg	49
Ukraine	48
Italy	47
Austria	46
Germany	46
Turkey	46
Total	44
Russia	44
Poland	42
Hungary	40
Spain	40
Norway	34
Czech Republic	33
Netherlands	31
Belgium	30
Sweden	29

Additionally, 16% of the respondents stated that their company management was not committed to combating fraud. Respondents from the following countries stood out as showing particularly high levels of non-commitment: France (23%), Greece (26%) and Italy (29%) in Western Europe, and Russia (22%), Ukraine (26%) and Romania (28%) in Central and Eastern Europe.

Of those respondents who did not believe that their company was at increased risk of fraud, 57% believed that their processes and procedures were adequate to prevent it. A further 45% of such individuals believed that the risk areas were sufficiently well covered. As businesses and the underlying risks that they face change, however, those processes and procedures may require revisiting.

Factors relied upon to counter fraud



Q You disagree that your company will be at increased risk of fraud. Why did you say that?

Percentages can total more than 100% as respondents can choose multiple answers.

Base: all those disagreeing their company will be at increased risk (927)

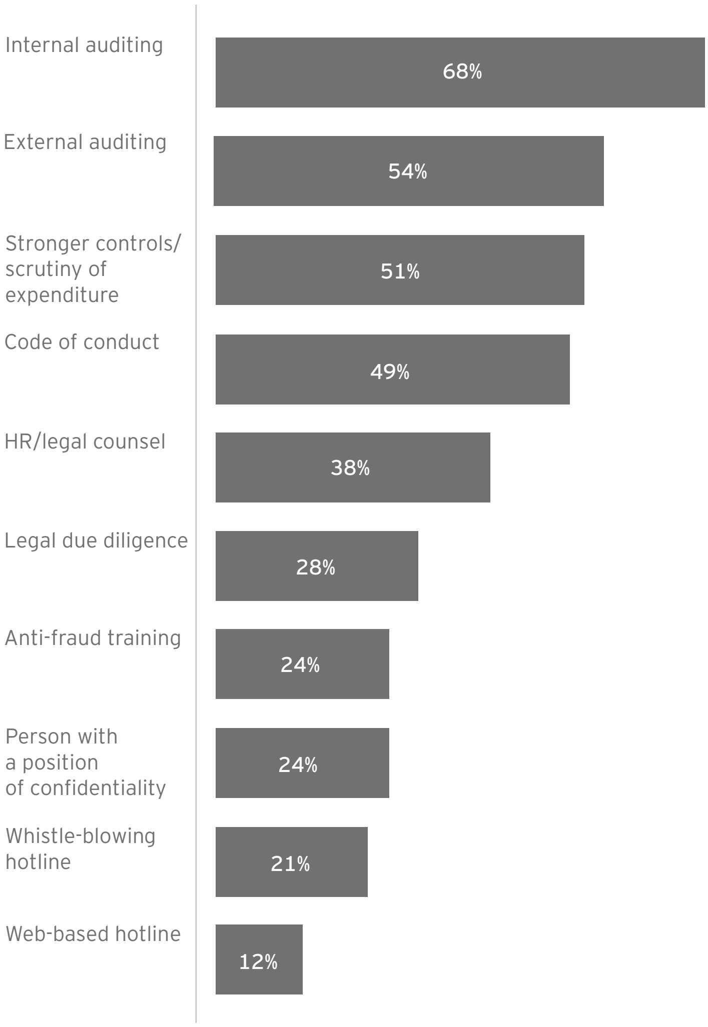
	Western Europe	Central and Eastern Europe
	%	%
Processes/procedures are adequate	55	59
Risk areas are well covered	43	51
Strong culture of integrity/honesty	46	28
I trust our management	40	39

What are companies relying on to counter fraud?

We see a general view that respondents see preventing fraud as someone else's responsibility. When we asked our respondents whether their company had certain anti-fraud measures in place, most suggested continued reliance on audit, either internal or external, as the primary response.

Internal audit teams are a key component of a company's fight against fraud. An effective team, with full support of the board and senior management, has the ability to assess and improve the performance of all aspects of an anti-fraud strategy, including the corporate culture and management's preparedness to respond to incidents of fraud.

Anti-fraud measures in place



Q Does your company have any of the following anti-fraud measures in place?
Percentages can total more than 100% as respondents can choose multiple answers.
Base: all respondents (2,246)

	Western Europe	Central and Eastern Europe
	%	%
Internal auditing	65	72
External auditing	52	58
Stronger controls	49	56
Code of conduct	51	45
HR/legal counsel	39	36

Current challenges to internal audit

A factor that may prevent internal audit acting effectively in an anti-fraud role is the strain on their resources. In the current economic environment, these demands are now combined with the challenges of addressing increased risks with a reduced internal audit budget. Given these pressures, heads of internal audit should give consideration to where they can achieve the biggest impact in the area of anti-fraud.

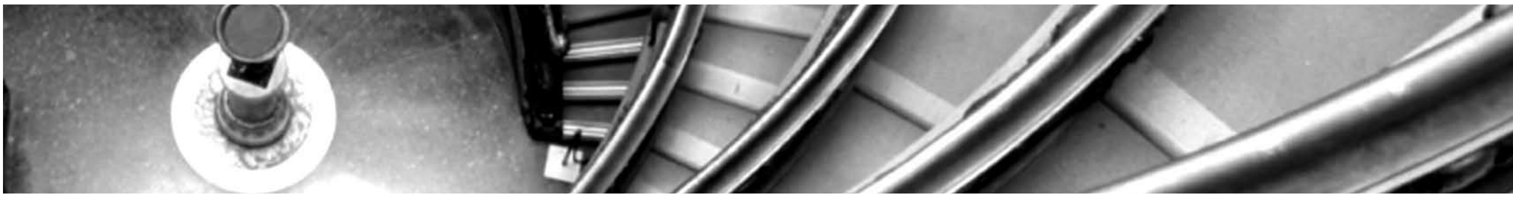
Given the limited resources available to many internal audit departments today, a fresh assessment of new and emerging fraud risks is warranted. So what are the emerging or more prevalent fraud risks? While many risks are industry specific, past recessions suggest that two of those likely to be on the rise are:

- Manipulation of financial statements driven by pressure to meet market expectations, to hide poor results or to maintain remuneration standards of executives.
- Asset stripping, whereby organizations in financial difficulties transfer assets to other entities leaving secured and unsecured creditors with shortfalls on liquidation.

Whistle-blowing

Experience shows us that one of the most frequent mechanisms by which fraud is discovered is through tip-offs. Despite this, only 21% of respondents to our survey cited the existence of a whistle-blowing hotline as one of their anti-fraud measures.

In jurisdictions where a whistle-blowing hotline can be used effectively as an anti-fraud measure, their success is attributed to the ability for allegations to be raised anonymously, to ensure allegations are directed to the attention of appropriate officers and are not blocked by reporting lines, and a trust in the process that allegations will be evaluated.



Whistle-blowing statistics should be reported periodically to both senior management and the board. The information reported should allow for appropriate review of usage of a whistle-blowing hotline, provide analysis of the types and, potentially, sources of allegations and the resultant outcomes of allegations.

Such reporting provides the following significant benefits:

- The volume or pattern of calls can indicate a lack of awareness or willingness of staff, or certain groups of staff, to use a hotline.
- It provides oversight by senior management and the board of the types of allegations that are being made and allows management to get quickly to the root cause of the issue. Management who receive such allegations will know that allegations cannot be ignored; people making the allegations will know that oversight of management will happen.
- Depending on how allegations are reported, it will highlight particular areas of the business which are achieving abnormal results and enable management to consider why.

A post-consolidation checklist

Following a period of major change your organization should ensure that it can still answer, as a minimum, the following questions:

- Does your organization have an appropriate approach and processes to enable fraud risk identification?
- Has your organization conducted a fraud risk assessment? If so, when was the last one conducted? Do you know the most common types of fraud in your industry today? Do you know what kind of fraud you are susceptible to within specific business functions or locations?
- Do you have internal controls to mitigate your key fraud risks? Are any of them automated? Have you tested their effectiveness?
- Are there written protocols to follow when a fraud is detected?
- Is your entire organization up to date on anti-fraud training?

Are management up to the challenge?

Our survey respondents have overwhelmingly questioned the ethical stance and integrity of management. If this collective doubt is well founded it may provide an explanation for the lackluster approach to anti-fraud despite the growing risks.

Management, in the opinion of our respondents, may fail to respond quickly enough, or in the worst case actually undermine anti-fraud initiatives.

What is certain is the cautionary tale our survey provides for those charged with governance and oversight — that management are not always to be trusted. Instead of increasing rigor, management are more likely to cut corners in response to the current pressures. Strikingly, these shortcuts are likely to include fraudulent activity, no matter how large or regulated the company, and some in senior management may well be the problem rather than part of the solution.

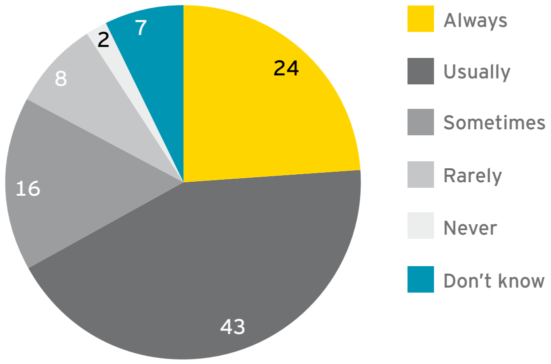
Integrity of leaders challenged

We asked our survey participants whether, in general, they felt that their company's management operate with a high level of personal integrity. Only a quarter said that this was always the case.

At a country level only 12% of respondents from Italy or France believed their management always operated with a high level of personal integrity. Similarly low expectations of management were held by respondents from Russia (14%) and the Czech Republic (13%).

This is less than a ringing endorsement for a group that is supposed to be taking the lead in preventing corruption and setting the tone at the top. Furthermore, it has implications for audit committees and their interaction with external auditors. Both would be well advised to strongly challenge management representations if their integrity is called into question.

Management's level of integrity

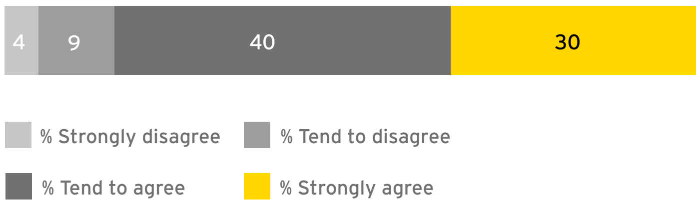


Q In general, do you feel your company's management personally operates with a high level of integrity?
Base: all respondents (2,246)

	Always/usually
	%
Western Europe	68
Central and Eastern Europe	64
Slovakia	95
Austria	87
Switzerland	85
Ireland	82
Luxembourg	78
Ukraine	76
Norway	75
Spain	71
Netherlands	70
UK	69
Total	67
Greece	67
Hungary	65
Germany	61
Romania	60
Belgium	58
Russia	58
Poland	57
Sweden	56
Czech Republic	55
Italy	52
France	51
Turkey	49

Unfortunately respondents consider it more than likely that management will succumb to temptation. More than two-thirds of our respondents agreed that management are likely to cut corners to meet targets when economic times are tough, with 30% agreeing strongly.

Management is likely to cut corners in tough times



Q **To what extent do you agree or disagree that company management is likely to cut corners to meet targets when economic times are tougher?**
Percentages total less than 100% as "don't know" answers have been excluded.
Base: all respondents (2,246)

	Strongly agree
	%
Western Europe	33
Central and Eastern Europe	24

Listed companies are no better

The tolerance of unethical behavior we found among our respondents is alarming. We asked them which of several actions they felt would be justified if made to help a business survive an economic downturn.

The option that would suggest fraud was deemed unjustifiable by our respondents was "none of the above" — but less than half (41%) picked it. Instead, a quarter felt that cash payments or personal gifts given to win or retain business were acceptable in a tough economy, and 8% would even tolerate misstating a company's financial performance. Respondents from listed companies generally fared no better.

This disregard for ethical conduct was not confined to less senior employees — in fact only 30% of senior management and board respondents indicated that "none of the above" was acceptable, substantially worse than the 44% indicated by other employees.

Justifiable actions to help businesses survive

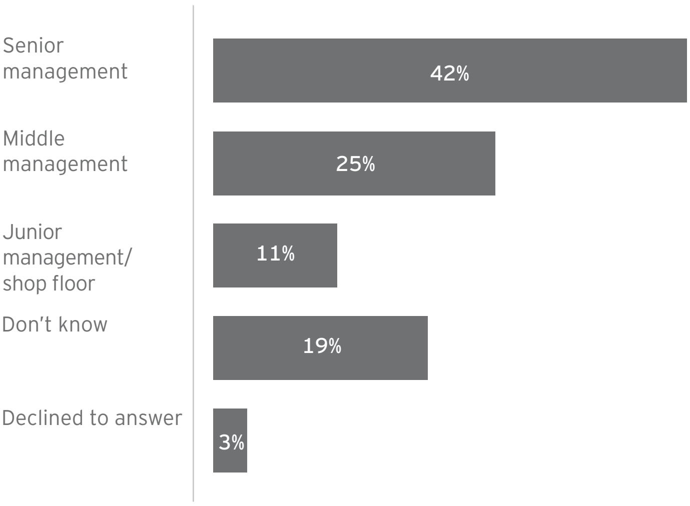
	All	Western Europe	UK	Germany	Spain	Central and Eastern Europe	Russia	Turkey	Czech Republic
Cash payments to win/retain business	25%	23	14	25	38	29	44	53	43
Personal gifts to win/retain business	24%	24	15	19	22	25	39	49	34
Entertainment to win/retain business	19%	22	25	19	18	15	13	32	19
Misstating company's financial performance	8%	6	3	7	4	11	14	10	6
None of the above	41%	45	59	47	34	34	36	18	31
Don't know	12%		12	12	11		5	7	7

Q Which of the following do you feel can be justified if they help a business survive an economic downturn?
Percentages can total more than 100% as respondents can choose multiple answers.
Base: all respondents (2,246)

Oversight roles require commitment and vigilance

Given the role that senior management has been found to have in many high-profile frauds, it is not surprising that our survey found 42% of respondents view senior management as posing the greatest fraud risk to the company.

Who presents the biggest fraud risk?



Q At what level of the organization would you say there is the biggest risk of fraud being committed?
Percentages can total more than 100% as respondents can choose multiple answers.
Base: all respondents (2,246)

	Western Europe	Central and Eastern Europe
	%	%
Senior management	39	46
Middle management	25	25
Junior management/ shop floor	12	9

We found that respondents are questioning whether management are truly committed to addressing fraud. In facing the challenges of the current environment, there will be a real temptation for management to override or circumvent procedures, to cut back on training, or to reduce oversight of third parties.

With opportunities and incentives for fraud abounding, respondents have overwhelmingly pointed the finger at management as potential culprits. Whether you are a member of an audit committee, or an active investor, the message is clear — you are strongly advised to go beyond management representations and assertions.

To redress this balance and given the increased risk of fraud, it is vital that senior management, together with the board, provide visible leadership by insisting that anti-fraud efforts are still a priority — through their actions as well as words. It means providing the necessary resources, taking disciplinary action where necessary and ensuring regular reviews of procedures.

Enforcement and compliance

Given the concerns expressed about management integrity and commitment to ethical conduct, it should not be surprising that survey respondents call for enhanced enforcement efforts by regulators. It would appear that they are turning to government to keep the pressure on management in order to mitigate increasing fraud risk.

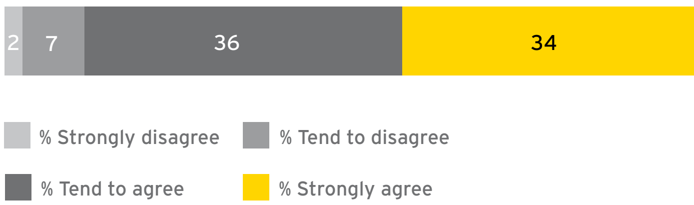
Indeed our research would suggest that much work remains for both boards and regulators if corporate fraud is to be substantially reduced. When asked whether they were confident that the company they worked for was free of significant fraud, a worrying 25% of our respondents from listed companies stated that they were not.

On an individual country level, the uncertainty over potential levels of fraud was often even more pronounced. In Italy (32%), Germany (42%) and Greece (45%) in Western Europe, and in Hungary (47%), the Czech Republic (49%) and Russia (54%) in Central and Eastern Europe, high proportions of respondents were not confident that their companies were free from fraud.

Employees are aware that the damage a significant fraud can have on a company can be massive. Consequences such as reduced access to finance and reputational damage can have a severe impact on a company's short-term and even long-term performance. In extreme cases, corporate collapse can be the result, and the viability of even the most robust company can be threatened.

As a consequence, the tolerance of our respondents for management failure with respect to fraud prevention and detection is minimal. When we asked employees whether directors should be made personally liable for lapses through fraud occurring under their watch, the result was a resounding "yes." 70% of our respondents agreed with this proposition.

Directors should be held personally liable for fraud



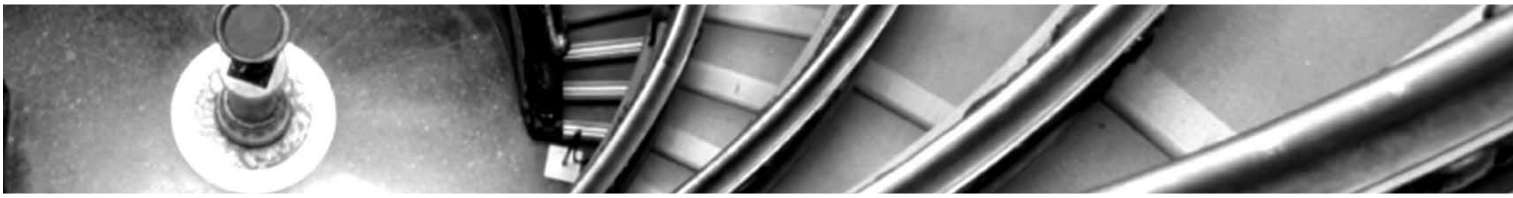
Q To what extent do you agree or disagree that companies' board of directors should be held personally liable for any lapses by their company in terms of corporate fraud?
Percentages total less than 100% as "don't know" answers have been excluded.
Base: all respondents (2,246)

	Strongly agree
	%
Western Europe	32
Central and Eastern Europe	38

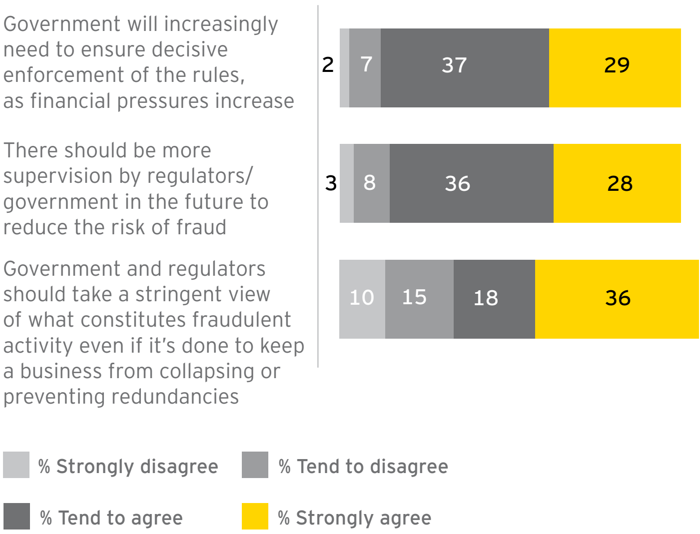
Across our respondents as a whole, two-thirds (66%) want to see existing rules enforced more decisively, and most want no reduction in the stringency with which regulators view fraudulent activity.

Respondents want so see:

- Existing rules enforced more decisively
- More supervision by regulators and government
- Government to be more stringent about what constitutes fraud.



Views on regulation and supervision



Q **To what extent do you agree or disagree with the following statements?**
Percentages total less than 100% as "don't know" answers have been excluded.
Base: all respondents (2,246)

Employees will probably not have to wait long, however. We see little chance that regulators will take a less stringent view of fraud. Given the gravity of the threat, government regulators in most countries are highly likely to take added measures to hold management and boards to account.

Regulators are increasingly looking to the board to take overall responsibility for setting the corporate tone for tackling the risk of fraud. This involves more than a few well-meaning speeches. It requires from management a continuing emphasis on communicating that commitment. This would include taking note of employee perceptions of the part played by management and directors.

Key management posts must be filled by people who are aligned with the company's values and objectives. The board must be prepared to challenge their decisions. Executive performance criteria should not create the pressures that can encourage fraud, but instead reward ethical business conduct. Regulators may well be prepared, in extreme cases, to seek prison sentences for senior management who fail to meet their obligations.

Protecting your assets, seizing opportunities in adversity

As a preventative measure, regulators are also likely to want to see proof that a company's cost cutting has not damaged the internal control environment. Where jurisdictions allow, they will want to see that a fully supported whistle-blower program is in place, and that senior company officials are visibly emphasizing the importance of combating fraud and corruption.

It is vital for the board to have a crisis management strategy in place that will allow a proportionate response to allegations or evidence of fraud. This may well involve providing external help to heads of business and heads of risk and security.

Senior management should ensure that adequate follow-up of control breaches occurs. Where fraud is suspected, they should move quickly to substantiate or disprove the allegations. An ill-considered reaction can expose the company further. For example, a premature confrontation with a suspected fraudster can undermine company morale if in fact the allegations prove to be false or misplaced. If the allegations are true, then the suspect has been given the chance to deny the allegation, destroy evidence and potentially hide misappropriated assets.

A well-defined fraud contingency plan can help companies to respond quickly, establishing responsibilities and reporting requirements and when to seek assistance from legal or other external advisors. Contacts in corporate, legal, IT security, internal audit, compliance, human resources and media relations should be nominated. Preferred supplier agreements are increasingly a good option for the larger corporate — fraud investigation is a specialized area, and hopefully not a steady or recurring problem but one that might require spikes of activity and resources. Whether it is mobilizing trained and experienced corporate investigators anywhere in the world, or securing electronic evidence in a rapid and forensically sound manner, heads of risk and security or internal audit can benefit from having an experienced advisor on hand.

Our research has identified a number of challenges for management in this difficult environment. By demonstrating their commitment to ethical business conduct, management will not only be protecting assets of the organization but positioning the company to seize opportunities in adversity.

Risk areas to review

Heads of business can be proactive too — preemptive measures can allow the business to manage any exposure internally, rather than in the public domain if schemes continue undetected and unchecked until they are inevitably laid bare. Greater scrutiny of risk areas should be commissioned and conducted outside of existing management hierarchies, for example, over:

- Continuing trends of cashflows failing to keep pace with earnings.
- Aged debtor analysis and potential exposure to schemes which map new receipts to old or non-existent debtors.
- Consignment stock or returns policies. Sales teams in trouble might at first saturate the supply chain to maintain sales levels, only to face the inevitable decline in margins as stock levels build or returns crystallize.
- Fictitious sales between group companies.
- Subjective write-downs of assets.
- Detailed assessment of procurement and disbursement activities, including the quality of contract award and supplier selection process documentation, decisions, approvals and beneficiaries.

Survey approach

In January and February 2009, our researchers conducted a total of 2,246 interviews with employees in 22 European countries either by telephone or online. Participants were employed in companies with over 1,000 employees, stock exchange-listed or multinationals.

Interviews were conducted using local languages in all countries.

Participant profile — region and country, company size, role, industry

Number of interviews	
Region and country	
Western Europe	1,428
Austria	100
Belgium	100
France	103
Germany	101
Greece	111
Ireland	100
Italy	101
Luxembourg	100
Netherlands	105
Norway	100
Spain	100
Sweden	106
Switzerland	101
UK	100

Number of interviews	
Region and country	
Central & Eastern Europe	818
Czech Republic	100
Hungary	105
Poland	108
Romania	100
Russia	102
Slovakia	101
Turkey	102
Ukraine	100

Number of employees globally	
	%
Above 5,000	48
1,500 – 4,999	22
1,000 – 1,499	11
500 – 999	11
250 – 499	4
Less than 250	2
Not available	2

Role within organization	
	%
Board director	1
Senior management	7
Junior management	28
Other employees	64

Industry sector	
	%
Manufacturing	16
Technology, communications and entertainment	13
Health sciences	11
Consumer products	10
Banking and capital markets	9
Professional firms and services	8
Transportation	8
Energy and utilities	7
Real estate and construction	6
Insurance	4
Other sectors	8

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