CGF
RESEARCH INSTITUTE
(PTY) LTD
Corporate Governance Framework®

ARTICLE

ECONOMIC CRIME IN SOUTH AFRICA: FACT OR FICTION?

Johannesburg
27 May 2015

Article by Terrance M. Booysen and peer reviewed by Sharon van Rooyen (Partner: EY)

It's a fact. No matter which global or regional surveys a person may refer to, the latest 2014/15 surveys on economic crime all show that crime of this nature is on the increase. Economic crime -- particularly *fraud and corruption* -- are causing organisations in both the public and private sector substantial financial losses, and increasing pressure on business to grow their revenues together with market volatility could be just some of the reasons why these crime statistics are increasing.

EY's Europe, Middle East, India and Africa ('EMEIA') 2015 Fraud Survey, entitled *Fraud and corruption – the easy option for growth?* found that greater pressure on businesses to grow revenues, together with market volatility was creating increased risk in expansion opportunities. Challenges -- including geopolitical instability, commodity and currency price volatility, as well as economic sanctions -- were pushing companies and their executives toward high-risk behaviour. Nearly thirty-three percent (33%) of the EY Fraud Survey respondents reported that management was under increased pressure to expand into higher risk markets. In these markets, sixty-one percent (61%) of respondents regarded corruption in companies as widespread, and thirty-seven percent (37%) of respondents reported that companies often overstate their financial performance.

"If there is a culture of never missing targets, some people will cheat to make the numbers. Their rationalization is that they are just doing what the top people want them to do. Directors and executives need to clearly communicate that ethics come before making targets. If this message is not consistently communicated, then the organization is headed for trouble."

Dana Hermanson, Dinos Eminent Scholar Chair of Private Enterprise at Kennesaw State University

In the 2014 *Report to the Nations on Occupational Fraud and Abuse*, conducted by the Association of Certified Fraud Examiners (ACFE), it found that whilst there was a higher percentage of fraud being committed by staff on the employee level, fraud committed by employees accounted for a much lower median loss than fraud committed by its executives. In the same ACFE report, it is interesting to note that accounting departments (as compared to seven other departments) were rated as the number one area where occupational fraud was most likely to occur. More interestingly though; was that whilst executives tended not to commit fraud as much as their junior counterparts, when executives did commit fraud, it was usually six times the value of those committed by their juniors. These findings were also corroborated in another fraud study, namely the 2014 Kroll Report, which was undertaken by the Economist Intelligence Unit with 901 senior executives polled globally. They reported that the following individuals were a leading figure in at least one fraud:

- 32% were senior or middle managers,
- 42% were junior employees, and
- 23% were agents or intermediaries.

In the 2014 Global Economic Crime Survey concluded by PricewaterhouseCoopers, out of the top five most reported crimes was Asset Misappropriation (69%), followed by Procurement Fraud (29%) and Bribery and Corruption (27%). This report furthermore stated for the first time since 2005, South Africa had shown an increase in the prevalence of economic crime. Whilst the global overall incidence of fraud increased from 2009 to 2011, South Africa recorded a fraud incident rate of sixty percent (60%) in 2011 and sixty-nine percent (69%) in 2013. Over the same period of time, the global average of fraud incidence was thirty-three percent (33%) and thirty-seven percent (37%) respectively. What is of grave concern for South Africa is that the country is reportedly experiencing a higher incidence of economic crime in every category, except in the categories of Intellectual Property Infringement and Mortgage Fraud.

Sadly this dire situation is not fictional and boards of directors should be critically concerned as statistics show as much as five percent (5%) of a company's turnover can be linked to fraud and corruption (ACFE). More concerning is that forensic investigators estimate that sixty-two percent (62%) of all fraud and corruption is committed internally by the organisation's employees (ACFE). This may be largely due to the fact that many organisations lack proper and effective internal controls to detect and prevent fraud, and organisations should be more proactive by implementing effective systems of internal controls that are designed to assist in the prevention of economic crime within an organisation. Not only should the system of internal controls be clearly articulated into the organisation's *Corporate*

Governance Framework® and risk matrices, but clear lines of accountability must be attributed to the board of directors when such controls fail, or worse, when these controls are missing. An organisation should be able to quickly detect when its internal controls are inadequate, and furthermore it should also know when there is any form of breaches of the controls, or a lack of management review and so forth. Indeed, this thinking is also in alignment with the recommendations contained in the King Report on Governance for South Africa of 2009 (King III), stating that "the board should report on the effectiveness of the company's system of internal controls". Clearly, when there is a poor tone being set at the top of the organisation and these controls are done haphazardly, then the organisation becomes particularly vulnerable to fraud.

Whilst organisations can become far more proactive in their fraud prevention and controls, they may benefit by implementing various types of pre-employment testing which can play an important role in the organisation's hiring policies and processes. Some of these pre-employment tests may include; director and employee background checks, drug tests, personality tests, cognitive tests and in special cases, polygraph tests.

Let's not forget the important role fulfilled by audit in the fight against corruption and the quest for a 'clean audit'. Both internal and external auditors are extremely useful resources to detect and prevent these criminal activities. Perhaps organisations should arrange more 'life-style' and 'surprise' audits in order to detect prohibited acts and this will make it more difficult for individuals to cover their tracks in anticipation of a planned audit.

It is interesting to note in EY's 2015 fraud survey (*Fraud and corruption – the easy option for growth?*) that as many as twenty percent (20%) of employees believe anti-corruption policies will hold them back from growing their business. That being said, it does make one wonder what *really* goes on within organisations and if the board *actually* wants to know how the bottom line figures were achieved by their employees?

"Fraud is ubiquitous; it does not discriminate in its occurrence. And while anti-fraud controls can effectively reduce the likelihood and potential impact of fraud, the truth is that no entity is immune to this threat. Unfortunately, however, many organizations still suffer from an 'it can't happen here' mindset."

Report to the Nations on Occupational Fraud and Abuse (2014)

Association of Certified Fraud Examiners

Indeed, directors should be reminded that contrary to popular belief, the board is ultimately accountable for detecting and preventing corporate fraud and this function does not rest with the external auditors, whose function is limited to expressing an opinion on the annual financial statements. The Global Leader of EY's Fraud Investigation and Dispute Services (FIDS) Practice -- namely David Stulb -- makes a solid argument stating that to "grow in a high-risk market you need the right controls and processes. You need your teams to be trained to make the right choice when asked to pay a bribe or 'cook the books', and you need the right tools to monitor activity so these risks can be addressed in a timely manner."

ENDS

Words: 1,134

More information regarding CGF governance services can be found at www.cgf.co.za or call +27 (11) 4768264 / 1/ 0

For further information contact:

CGF Research Institute (Pty) Ltd
Terrance M. Booysen (Chief Executive Officer)
Tel: 011 476 8261 / 0
tbooysen@cgf.co.za

EY
Sharon van Rooyen (Partner)
Tel: 011 772 3000
E-mail: sharon.vanrooyen@za.ey.com