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Advisory
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Economic crime: people, culture & controls*

The 4th biennial Global Economic Crime Survey

Hungary

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Introduction

We are pleased to present the results of the PricewaterhouseCoopers Global Economic Crime Survey 2007. We have interviewed senior representatives of more than 5,400 companies in 40 countries, including 77 leading companies within Hungary, providing us with unparalleled depth of insight into perceptions, awareness and impact of economic crime on business around the world.

To ensure the complete confidentiality of responses, the survey was conducted on behalf of PricewaterhouseCoopers by the internationally renowned market and social research institute, TNS Emnid. In subsequent data analysis, we cooperated with Prof. Dr. Kai

Busmann, Chair of Criminology & Penal Law at Martin-Luther University in Halle-Wittenberg, as well as the independent Economic Crime Research Centre at the Martin-Luther University.

Apart from the actual company survey, in which businesses report their experiences in their own fight against economic crime, we also asked victimized companies to provide us with detailed information on the most serious real-life crime incidents. This helped us to prepare a detailed profile of fraud perpetrators and examine the complicated interrelationship between comprehensive controls and corporate culture. We believe that the results of our analysis in these areas

will allow companies to better understand the significant impact that economic crime can have on their business, assess the risks of fraud that they may face, and find ways to mitigate those risks.

Our survey reveals that fraud remains one of the most problematic issues for business worldwide. Across the globe, 43% of companies surveyed reported that they have been the victims of economic crime in the last two years. In Hungary, the overall figure is 62%, which is well above the average for Central and Eastern Europe (CEE) of 50%, and a huge increase when compared to our last Economic Crime Survey in 2005 (25%).

Key findings for Hungary¹

- Economic crime is a major problem in Hungary. Almost two-thirds (62%) of the companies surveyed in Hungary have fallen victim to economic crime over the past two years – a striking increase from our previous survey (25%). On average, Hungarian respondents had suffered 8.9 cases of fraud.
- The most common economic crimes reported by our respondents in Hungary are asset misappropriation (reported by 48% of companies), followed by IP infringement (26%) and corruption and bribery (17%).
- However, corruption and bribery is still perceived to be the greatest threat – 31% of all companies believe that corruption and bribery is the most prevalent type of economic crime in Hungary. Despite this perception, however, only 17% of companies surveyed reported that they had actually suffered from corruption and bribery.
- Fraud is extremely expensive for Hungarian companies – economic crime costs the companies surveyed in Hungary almost USD 21 million in the past two years (of which approximately USD 8 million related to asset misappropriation, USD 7.6 million to corruption and bribery, and USD 1 million from IP infringement), with average losses per company from economic crime being USD 334,000 in this period.
- Hungarian companies surveyed also spent more than USD 4.5 million over the last two years in managing their cases of economic crime (for example in legal costs, investigation costs etc).
- Furthermore, in addition to the direct and remediation costs related to economic crime, 67% of respondents indicated that they had suffered “collateral damage” such as damage to their reputation, decreased staff motivation, the distraction of management, and the impairment of business relationships.
- Over one third (34%) of the perpetrators of the most serious offences were employed by the defrauded entity. An external party was involved in more than 90% of all of the reported fraud cases, serious or non-serious, indicating frequent collaboration between internal and external fraudsters. The typical perpetrators of the most serious offences continue to be male (90%), between the ages of 31 and 50 (80%), and educated up to graduate level (64%).
- The main fraud drivers behind the most serious reported frauds in Hungary were the perpetrators’ need to maintain an expensive lifestyle, their low temptation threshold, as well as their ability to commit fraud as a result of both internal and external collaboration.
- Criminal (57%) and/or civil charges (41%) were brought against the perpetrators of the most serious crimes reported. Worryingly, 14% of the companies surveyed stated that they had taken no action against the perpetrator(s). Additionally, 31% of the perpetrators were not sentenced, highlighting the need for companies to ensure that sufficient and appropriate evidence is collected during any fraud investigation.
- Hungarian companies display a degree of unjustified complacency about the dangers of economic crime - whilst 62% of companies reported to have fallen victim to economic crime in our survey, almost 65% of respondents considered it very unlikely that their companies would suffer from economic crime over the next two years, while 20% of the surveyed companies have no specific actions planned to deal with the problem of economic crime in the future.
- This possible complacency is further highlighted by the methods by which reported incidences of economic crime were identified. Despite the respondents’ growing confidence in their risk management systems, nearly 30% of the most serious reported cases in Hungary were initially detected by chance (i.e. by accident or from tip-offs). By far the most successful company-introduced fraud detection mechanism in Hungary was the internal audit function, which detected 32% of the most serious economic crimes reported in Hungary.
- 65% of respondents indicated that they had not recovered any lost funds. 73% of companies in Hungary do not have insurance to cover the losses and costs of economic crime, compared to a global average of 61%.

¹ Unless otherwise stated, all figures refer to Hungary



Fraud – a major business risk in Hungary

Our 2007 Economic Crime Survey reveals that 62% of companies surveyed in Hungary reported being subject to one or more significant economic crimes during the previous two years. This is nearly two-and-a-half times higher than in our last survey in 2005, when only 25% of respondents reported being victims of economic crime. It is also well above the CEE (50%) and global (43%) averages. On average, Hungarian respondents had suffered 8.9 cases of fraud in the last two-year period.

Does this mean that economic crime in Hungary has really increased so dramatically in the period since our last survey? While a substantial increase in economic crime in Hungary may well be one of the reasons for the 37 percentage point rise since our 2005 survey (and there has been a dramatic increase in the levels of IP infringement reported,

from 7% in 2005 to 26% in 2007), we believe that the following factors may have also played a role in the increase in the number of reported economic crimes:

- A greater awareness of economic crime within Hungarian organisations and therefore a corresponding increase in its reporting;
- An increase in corporate transparency;
- A decrease in the stigma attached to economic crime in Hungary, which may now be perceived as less of a taboo subject. It could be the case that the level of economic crime reported in our 2005 survey of 25% significantly understated the true position; and
- The introduction of more stringent controls and risk management systems, which enable companies to detect more cases of fraud.

This trend in Hungary is somewhat consistent with our findings from CEE as a whole – the level of reported economic crime has increased (from 47% to 50%), while the average number of incidences reported per company has increased dramatically across the CEE, from 6.7 in the two years to 2005, to the 12.9 incidences reported in our 2007 survey.

Types of economic crime

The most common types of economic crime reported in Hungary (in terms of the actual number of incidences) were asset misappropriation (48%), IP infringement (26%) and corruption and bribery (17%).

Although more than one-quarter of companies reported incidences of IP infringement (a striking increase since 2005), in monetary terms,

asset misappropriation and corruption and bribery were by far the most expensive forms of economic crime for the Hungarian companies surveyed – of the total direct costs of economic crime of USD 21 million, almost three-quarters related to asset misappropriation and corruption and bribery (USD 8 million and USD 7.6 million respectively), while respondents reported losses of “only” USD 1 million arising from IP infringement in the previous two years.

The level of asset misappropriation in Hungary (48%) was considerably higher than the reported levels in CEE (33%) and globally (30%). This is most likely due to the fact that of the surveyed companies in Hungary, almost 12% operate in the retail sector, a much higher proportion than

in CEE (5.4%) and globally (5.9%). The retail sector, with its high volumes of often high value and easily moveable goods, is by its very nature, more prone to asset misappropriation than most other industry sectors.

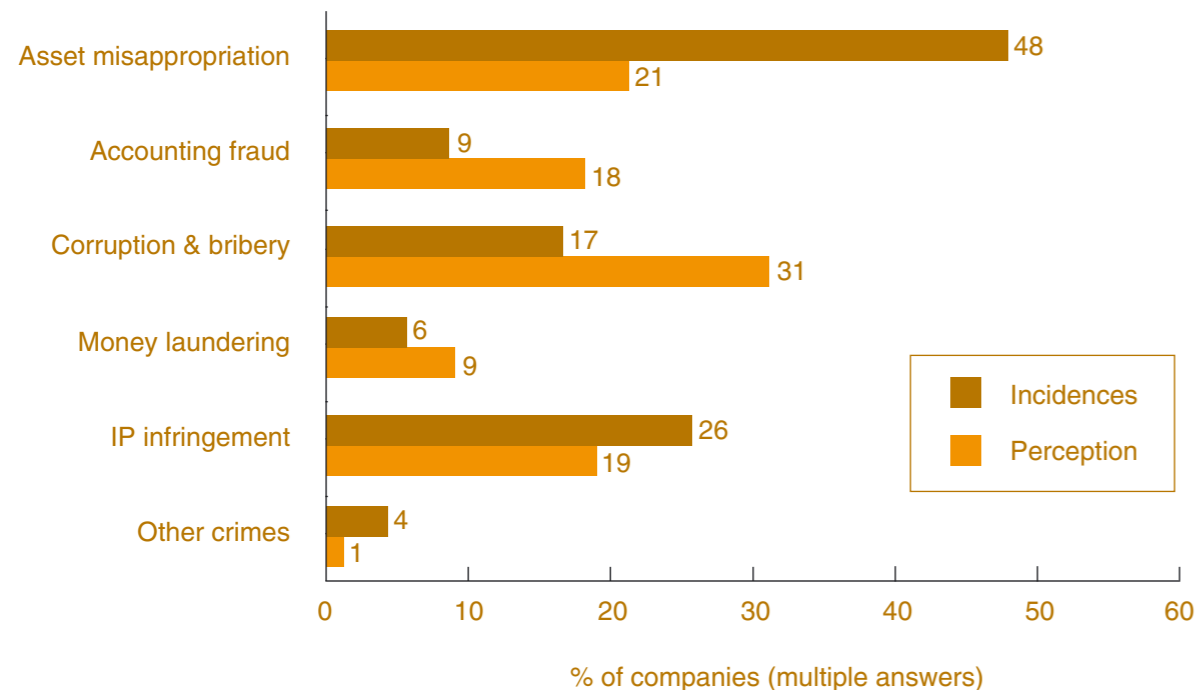
In each of our surveys, we have offered a comparison between the views held by executives regarding which types of crime they think are prevalent (“perception”) and those which they have actually suffered (“prevalence”). There continues to be a mismatch between perception and actual incidence insofar as types of economic crime are concerned.

The gap between perception and reality is particularly wide in respect of asset misappropriation and corruption and bribery. While 48% of Hungarian companies surveyed reported having been a victim of asset misappropriation, only 21% of respondents considered asset misappropriation to be prevalent in Hungary, which suggests that Hungarian companies underestimate

the threat of this type of economic crime (further highlighted by the belief of 47% of Hungarian companies surveyed that it was very unlikely that they will suffer from asset misappropriation in the next two years).

The situation is reversed in relation to corruption and bribery, which continues to be perceived as the most prevalent type of economic crime by 31% of surveyed companies, yet only 17% of respondents reported that they had been victims of corruption. However, in the case of corruption and bribery, the perception may be closer to reality (see box), given that 29% of respondents stated that they had been asked for a bribe in the past two years, and 44% believed that they had lost opportunities to competitors who may have paid bribes.

Comparison of perception and incidences



Corruption – perceptions truer than reality?

What is the true incidence of corruption and bribery? Part of the difficulty in assessing the real levels of corruption and bribery relates to the nature of this crime. Corruption and bribery is often reported in the media and has been a hot topic in Hungary and throughout CEE for a number of years. Hence, it is much more in the public eye than other types of economic crime thus potentially increasing the perception of its incidence versus other, less publicised types of crime such as asset misappropriation or financial accounting fraud. On the other hand, corruption and bribery can be very difficult to prove thus potentially reducing the number of reported cases.

Further analysis reveals that respondents’ perceptions of the risks of this particular economic crime in their home countries were very similar to the worldwide findings reported in Transparency International’s Corruption Perception Index of 2006 (CPI). This may be because many managers, while being reluctant to report on corruption in their own company, are quite able to provide a realistic estimate of their national risks. Furthermore, their opinions of corruption are influenced by definitions that employ neutral terms and may still regard this particular economic crime as one that is peculiar to public sector organisations and government. It is possible – even probable – that companies’ perceptions generally appear to be more valid than the low actual incidence rates for corruption and bribery reported.

The cost of fraud

Fraud is a costly business. Globally, the average cost of economic crime over the last two years was approximately USD 2.4 million per company (up from USD 1.7 million in 2005), with the total loss of companies surveyed around the world exceeding USD 4.2 billion. The direct losses as a result of reported cases of economic crime in Hungary totalled USD 21 million or an average of approximately USD 334,000 for each company reporting incidences of economic crime over the past two years. This level of loss becomes more significant when one considers that 44% of the companies surveyed in Hungary had less than 200 employees.

Over and above the direct losses suffered as a result of reported economic crime, our Hungarian respondents also reported having spent in total an additional

USD 4.5 million in managing the economic crimes reported (on average USD 67,000 per company). Costs of managing economic crime include, for example, legal costs, investigation costs, and also costs arising from reallocating management time/priorities and the need to manage additional public relations and investor relations campaigns or dealing with regulatory issues arising from the economic crime committed. Hungarian companies are spending much less on average in managing cases of economic crime, when compared to the CEE average of approximately USD 582,000 per company. This could suggest that Hungarian companies are failing to investigate economic crimes adequately once they have been identified, and that as a result, the actual direct losses suffered as reported in our survey may be understated.

While the direct reported costs of economic crime (and the managing costs) seem alarming enough, one should not ignore the “collateral damage” from fraud, i.e. damage to a company’s brand and customer trust; to the share price and shareholder trust; to the company’s relationships with its suppliers; and decline in staff morale which can result in high staff turnover and loss of productivity. Although difficult to quantify, collateral damage can be a significant cost to a business. Nearly 67% of Hungarian respondents who suffered fraud reported collateral damage to their business as a result. This is significantly higher than the global figure of approximately 55%. Hungarian companies considered that management distraction, the expense of litigation, and more difficult relations with regulators to be the most significant collateral damage they had suffered in the last two years.

Means of detecting and preventing fraud

The means by which fraud is detected can be split into two broad categories: detection by chance and detection through risk management controls and systems. Worryingly, nearly one third of economic crime in Hungary (30%) was detected by chance (a combination of internal/external tip-offs and accidental detection), which represents a slight deterioration from our 2005 survey, when 29% of fraud cases were detected by chance.

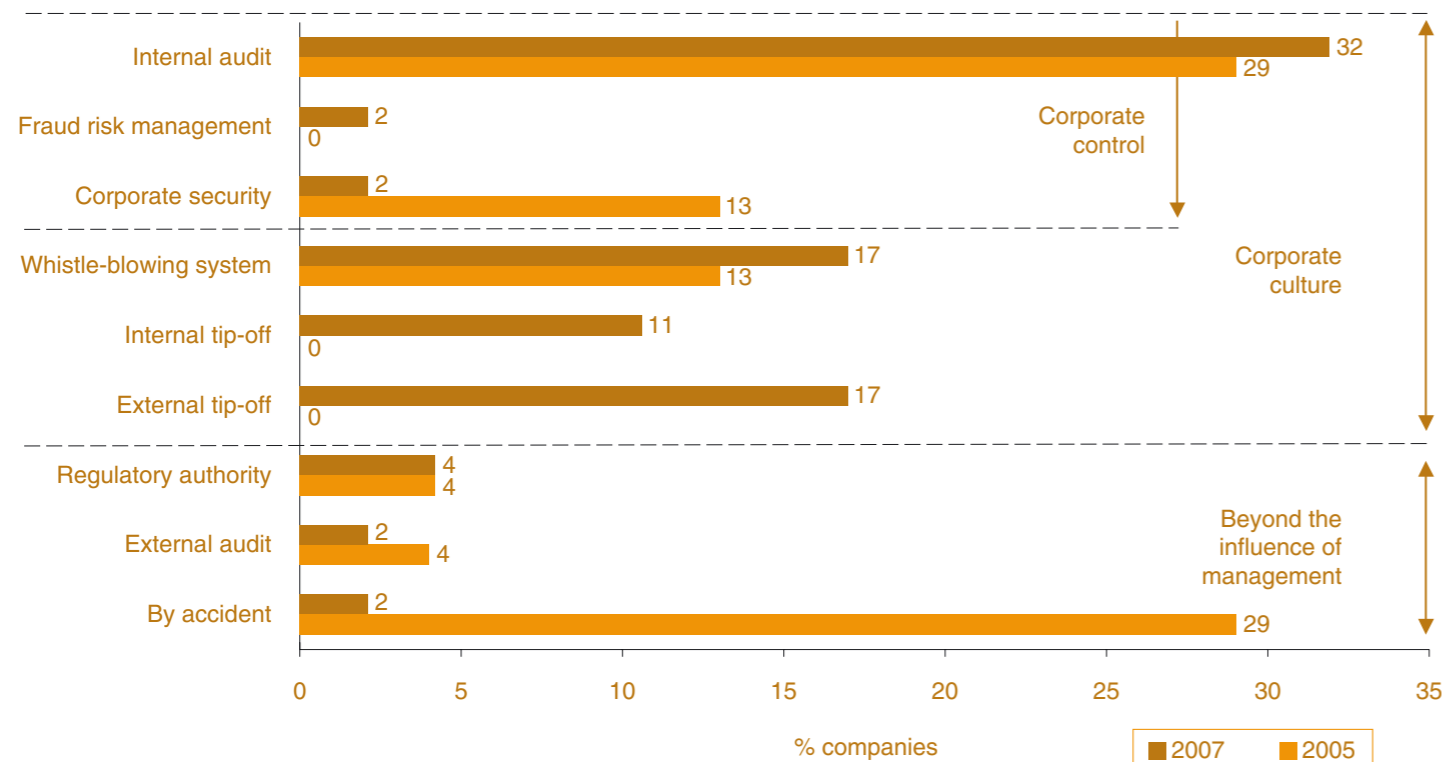
This could be the result of Hungarian companies now having fewer measures in place to discover and prevent economic crime (7.6 on average), which is both lower than

the CEE and global averages (8.6 and 9.0 measures respectively), but also represents a decline since our last survey, when Hungarian companies reported that they had, on average, 8.5 measures in place to detect and prevent fraud. This is particularly concerning given that our 2007 survey has identified a sharply higher level of reported economic crime in Hungary when compared to our 2005 survey – Hungarian companies should not be relying on chance to identify incidences of economic crime.

Internal audit remains the most successful control in detecting economic crime in Hungary (32% of initial detections). The next

most important way of fraud detection (ignoring accidental discovery) was whistle blowing (17%), a method by which concerns can be reported on an anonymous basis (up from 13% in 2005). From our 2007 survey, the number of companies that have introduced whistle blowing programmes has increased by 10 percentage points to 31% when compared to 2005 and that seems to have started bearing fruit. In fact, in terms of the detection of economic crime, whistle blowing in Hungary has been something of a success story, and it now exceeds the 2007 global (8%) and CEE (10%) figures for fraud detection. More Hungarian companies should consider implementing such programmes (see box).

How was the case initially detected?



Whistle blowing Programs: Best Practice Tips

- Safeguard employees who report misconduct. Allow for anonymous reporting.
- Make certain employees can report incidents outside their chain of command – by using a helpline, e-mail or mail box.
- Maintain confidentiality to the fullest extent possible.
- Establish a company code of conduct that requires full cooperation of management and employees in any investigation.
- Train and periodically update all company employees about the whistle blowing program, disciplinary policy and the company code of conduct.
- Formalize processes for recording and tracking reported issues and incidents.
- Establish communication channels not only for reporting, but also for asking questions and receiving guidance.
- Communicate information about the reporting and investigation process, how it operates, what issues have arisen and how they will be solved.
- Assign appropriate people with both the requisite authority and experience to perform the investigation.
- Establish and consistently enforce a disciplinary policy.

The Hungarian companies surveyed displayed a degree of complacency about the dangers of economic crime – whilst 62% of companies reported they had fallen victim to economic crime, almost 65% of respondents considered it very unlikely that their companies would suffer from economic crime over the next two years, while 20% of the surveyed companies have no specific actions planned to deal with the problem of economic crime in the future. This possible complacency is further highlighted by the methods by which reported incidences of economic crime were identified (discussed above) with nearly 30% of the most serious reported cases in Hungary being initially detected by chance.

We also asked our respondents if they had introduced any new fraud prevention and detection measures in the last two years. As noted above, the average number of such measures per company in Hungary has actually fallen since 2005. For those respondents who had

introduced new controls in this period, it is noteworthy that incidences of economic crime they may have suffered from were not named as being the key driver behind implementing these new measures: rather, it appears that complying with local legislation and also the Sarbanes-Oxley Act were the main reasons new measures were introduced, again suggesting that Hungarian companies may not be taking the risk of economic crime seriously enough, and are simply “going through the motions”.

The drivers for fraud

For someone to commit fraud, it is generally accepted by criminologists and fraud investigators that three conditions must be present: the opportunity to commit fraud, the incentive to commit fraud, and the fraudster’s ability to rationalise their own actions.

For the purpose of this research, we simplified these into two areas:
a) the perpetrators’ personal reasons for committing fraud (i.e. their incentive and ability to rationalise their actions to themselves); and
b) the organisational reasons that allowed fraud to occur (i.e. the levels of control and the ethical culture in the firm).

Respondents were asked to categorise the perpetrators’ incentives, opportunities, and means of rationalising their crimes (in respect of the two most serious offences our respondents had been victims of in the last two years).

In terms of fraudsters personal reasons, what stood out in Hungarian companies were:

- The perpetrators’ financial/materialistic incentive: greed (48%) and the need to maintain an expensive lifestyle (28%);
- Means of self-rationalisation: the perpetrators’ low temptation threshold (34%) and the

perpetrators’ denial of the financial consequences of the result of their actions i.e. the erroneous perception that fraud is a “victimless crime” and hurts no one (39%).

In terms of the organisational reasons that allowed fraud to take place, what was apparent was the high level of collaboration that enabled the reported incidences of economic crime to take place. Our respondents said that internal collaboration was involved in 30% of the most serious cases suffered, and external collaboration in 29% (collaboration with external parties is particularly important in Hungary given that in ALL cases reported (not just the most serious offences), our respondents stated that an external party had been involved in 90% of cases).

Worryingly for Hungarian companies, the perpetrator’s low commitment to the company and its brand were cited as a reason that allowed the fraud to take place in 30% of the most serious offences reported. In conjunction with

the level of collaboration taking place between company employees, and also company employees and external parties, this suggests that Hungarian companies need to improve their corporate “culture”, ensure that employees are motivated and committed to their employer, and that the company’s code of ethics is communicated effectively. A company’s culture is vital in establishing an ongoing, effective, fraud risk management programme.

The typical perpetrator

The typical perpetrator of the most serious cases of economic crime in Hungary was male (90%), between the ages of 31 and 50 (80%), while 55% of fraudsters were educated to university degree level. These statistics are very similar to the CEE region as a whole.

While fraud is perpetrated by all levels of staff within businesses, what is startling is the extent to which our

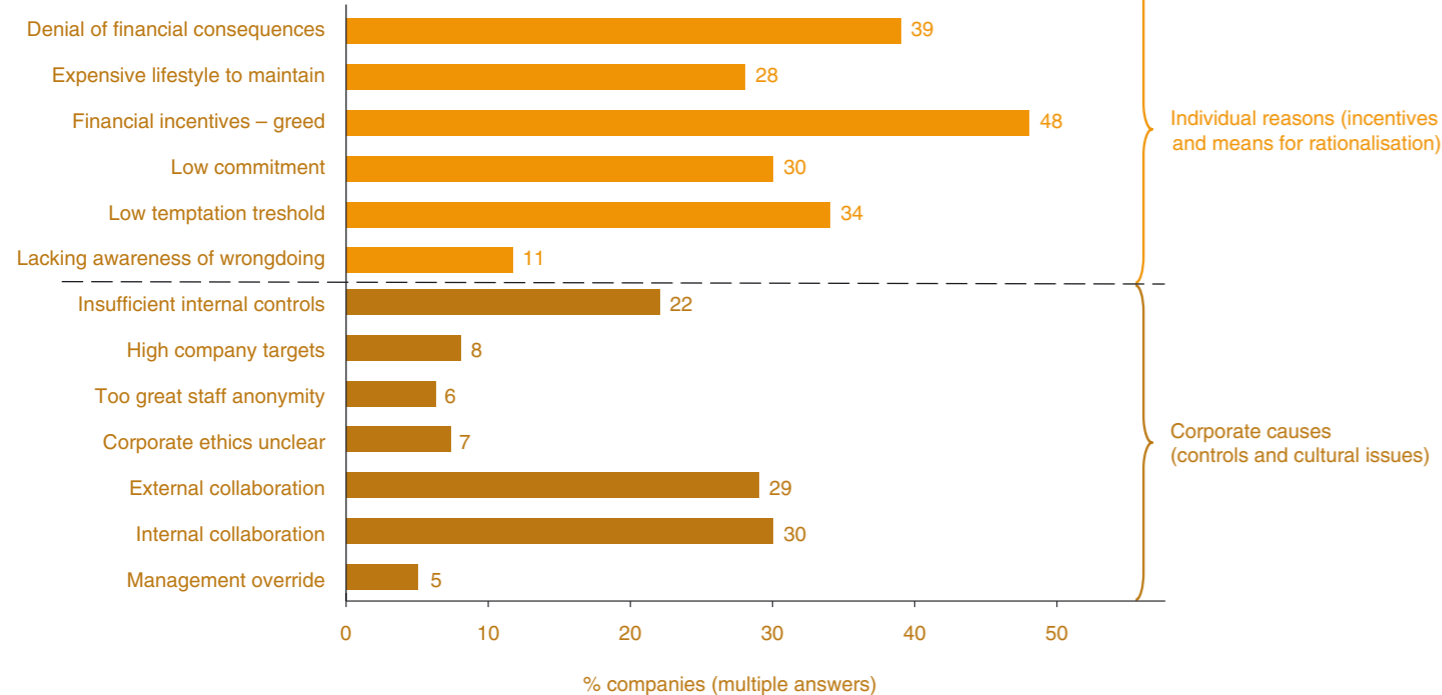
survey showed members of middle and senior management – the figureheads within a business – are involved in frauds. In Hungary, members of senior management were responsible for 27% of reported frauds (lower than the CEE region as a whole – 38%, but higher than the global figure of 20%) whilst middle management were responsible for 20% of internally committed frauds.

Naturally, such fraudsters tend to have an opportunity to use their management authority to override controls designed to detect fraud. More importantly, our global research shows that the frauds committed by senior and middle management cause the greatest financial and collateral damage to a business.²

It is noteworthy that 73% of internal perpetrators tend to commit their crime during the first two years of entering into their new positions and 55% of internal perpetrators tend to commit their crime during the first two years of their employment at their companies.

2 For more details, see PwC Global Economic Crime Survey 2007, pg. 20

Reasons for committing fraud



Dealing with fraudsters

An important step in creating a corporate culture that does not tolerate fraud is consistency of action when an economic crime is detected. When the staff understand the consequences of their potential foray into fraud, and that detection is certain and inevitable due to sophisticated and effective risk management systems, this serves to deter most fraudsters.

In our view, once an incidence of economic crime has become known it is vitally important to signal to staff

that all of the perpetrators are treated the same way, regardless of their position within the company.

Once the alleged fraud has been detected, steps must be taken to investigate and authenticate any such claims. Our survey shows that Hungarian companies prefer to investigate serious offences primarily in-house, i.e. involving in-house counsel (68% of reported cases), internal auditors (56%) and other internals (62%). External parties are used much less frequently to investigate economic crimes, such as forensic accountants (13%), external auditors (18%) and lawyers (29%).

These results may indicate unwillingness on the part of management to report fraud related issues externally. A lack of openness can give rise to an environment in which fraud can take place. Also, given the low level of sentencing against perpetrators (see below), investigating the matter internally may not be the best course of action – internal staff may not have the appropriate skills to investigate and collect the evidence in a manner sufficient to secure successful prosecutions.

Once a company confirms a suspected fraud, appropriate action against the perpetrator is essential in order to deter other potential fraudsters and to show stakeholders in the business that the organisation will not tolerate such malpractice. It is a concern that in 14% of the most serious cases reported, no action was taken by companies against the perpetrators, although criminal charges were raised in almost 60% of the cases.

However, only 19% of the perpetrators of the most serious offences in Hungary have actually been sentenced, while 50% of cases have yet to come to trial. 31% of the perpetrators were not sentenced (i.e. not punished), highlighting the importance of conducting investigations in a way that ensures the integrity of evidence for court purposes. For those perpetrators who have been successfully prosecuted and sentenced, punishments are relatively light – although all perpetrators sentenced have to return 100% of the stolen monies, 75% of those sentenced (for the most serious offences) received a prison sentence of less than three years.

Hungarian respondents. Only 27% of companies in Hungary have insurance to cover losses and costs from economic crime, compared to the global average of 39% – the low level of recovery of losses from insurance may be an indication that companies are not taking out the appropriate insurance to cover all instances of economic crime.

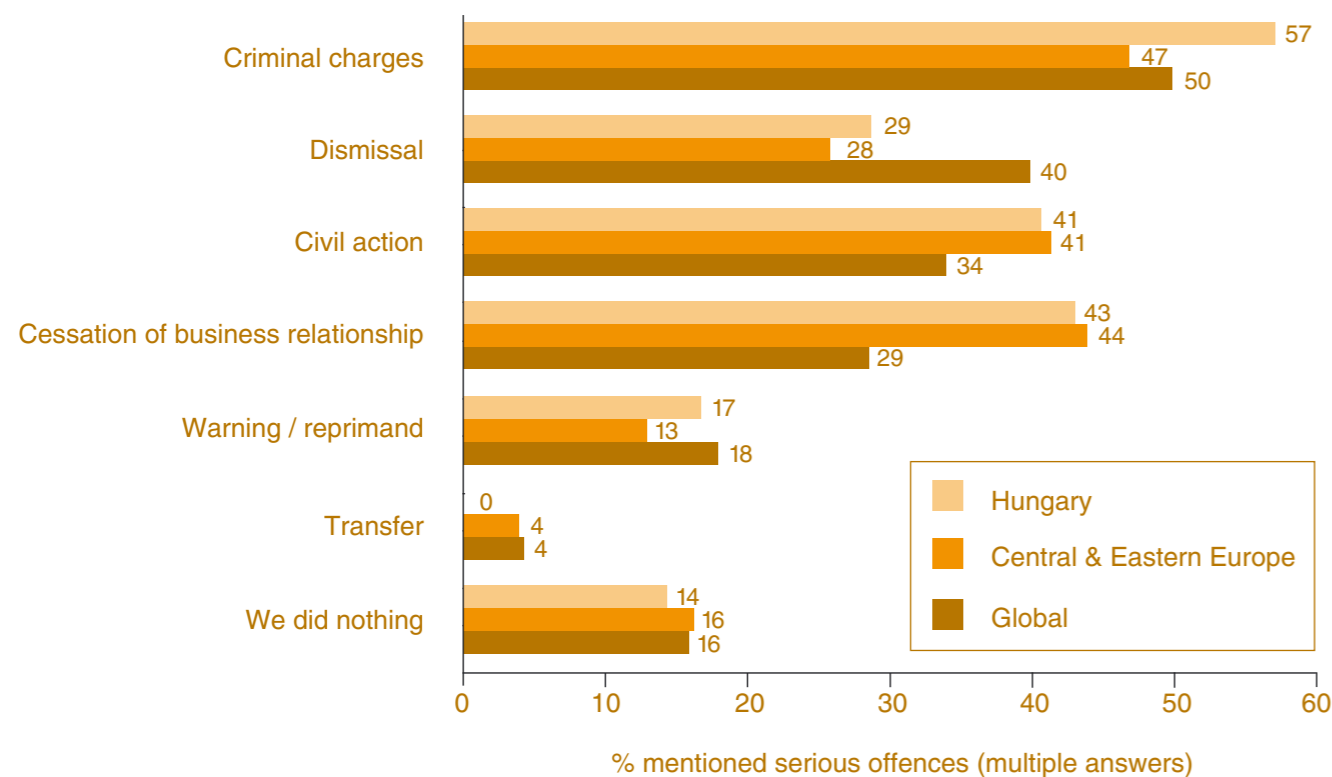
Fraud in the future

Fraud remains a serious and intractable problem. On a global scale, levels of economic crime have not dropped significantly over the course of the decade and despite that, companies continue to be confident – as they have with every study that we have conducted – that their controls will limit their exposure to fraud in the future. The same goes for Hungary, where despite almost two thirds of companies surveyed stating that they had suffered from economic crime in the past two years, nearly 82% of companies believe that it is unlikely that their organisation

would become victims of economic crime in the next two years. In our opinion this may well be a sign of over-confidence, especially given the large proportion of fraud which was detected by chance.

The fight against fraud is a constant struggle, and Hungarian companies must not let their guard down for a moment – complacency or ignoring the problem are not viable options. Our biennial study continues to show that in order to assess and manage its risks, a constant re-evaluation of all fraud risk management activities is necessary. Equally importantly, companies must strive to establish a culture that supports anti-fraud controls with clear and ethical guidelines, engendering loyalty to the organisation’s brand, and showing (through retroactive action) that every perpetrator, no matter what their position and function in the company, will be subject to equivalent sanctions. As with all crimes and unwanted business risks, a move from after the fact reaction to prevention is the most valuable move.

Actions taken against the main perpetrator



Recovery of lost assets

Besides deterring other fraudsters with a prompt and decisive response, recovering financial losses is another important aim for companies. However, Hungarian companies are poor at recovering losses from economic crime – 65% of companies stated they recovered nothing in relation to the most serious offences suffered (higher than the global average of 58%).

Insurance continues to play a small role in recouping losses from economic crime – on average only 13% of the amount lost was recovered under insurance policies by

Key Elements of Effective Anti-Bribery Compliance Programs

1. Create a control environment with the right structure and tone:
 - CEO communication on “zero tolerance” for illegal acts and misconduct;
 - Establish high quality, compliance organization with well trained staff and clear processes.
2. Focus on the most important compliance risks:
 - Perform risk assessments to identify high risk areas
 - Adapt processes based upon the nature and source of risk.
3. Design compliance control activities to minimize risk of non-compliance:
 - Establish control procedures for high bribery risk areas;
 - Adopt protocols for investigating allegations of misconduct, illegal and non-compliance.
4. Establish processes and systems supporting compliance:
 - Ensure effective reporting to key corporate governing bodies;
 - Embed compliance into the IT systems.