

Economic crime: people, culture & controls

The 4th biennial Global Economic Crime Survey
Transportation and Logistics industry supplement



In this industry supplement to *Economic crime: people, culture & controls: The 4th biennial Global Economic Crime Survey*¹ we examine data from 191 Transportation and Logistics (T&L) companies in 35 countries and compare and contrast their views with those of executives across all industries (as well as T&L executives interviewed in our 2005 survey).

Economic crime is a serious issue for the T&L industry. Respondents from T&L companies reported higher costs of economic crime over the past two years, although the overall rate of economic crime was down slightly. Our survey only looks at detected economic crime; actual rates of fraud are likely to be much higher. The Association of Certified Fraud Examiners (ACFE) estimates that economic crime levels are probably closer to around 5% of company revenues².

And while the direct financial costs of economic crime are likely substantial, the indirect or collateral damage to one of T&L companies' most valuable assets – their reputation and brand value – may potentially have even more far-reaching negative consequences. Economic crime consists of far more than just stealing

goods – other types of fraud such as corruption and bribery and accounting fraud can be far more damaging than outright theft, as their exposure may impact relationships with customers or the value of the brand.

The most common means of detecting fraud in the T&L industry continues to be via chance mechanisms, such as internal or external tip-offs, or by accident. Still, in comparison with other industries, T&L companies are doing some things well; the rate of chance detection is lower than in other industry sectors, and corporate security has emerged as a relatively effective mechanism for detecting fraud in the industry. On the other hand, detection rates via internal audit have declined versus 2005. In some key indicators of company culture, T&L companies are also coming up short, which could lead to future increases in economic crime.

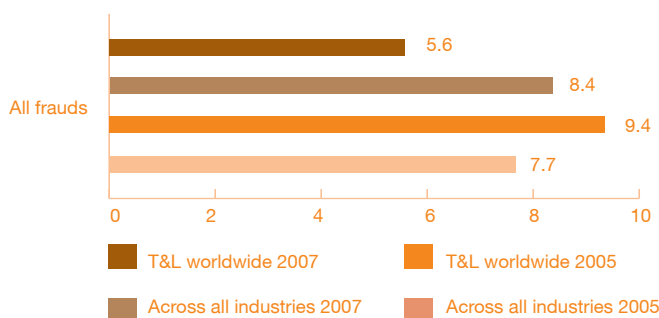
We hope that this report will help to highlight the importance of this issue to T&L industry executives, stimulate discussion and aid in the development of increasingly effective means of combating economic crime.

Some good news – the economic crime rate is down

T&L companies reported somewhat lower levels of economic crime. Overall, 37% of companies reported incidents of economic crime, compared to 43% of companies across all industries, and 45% of T&L companies responding to the 2005 survey. Respondents also reported fewer incidents than peers in other industries, in contrast with 2005, where the number of incidents was higher than in other sectors (see figure 1).

In particular, T&L companies are suffering much less from asset misappropriation. Only 24% of respondents reported this type of economic crime, down from 33% in 2005, and less than the rate across industries (30%; see figure 2). Asset misappropriation in the industry can take a number of forms, from cargo theft during the shipping process, to more elaborate fraud schemes. As the backbone of global supply chains, the T&L industry has instituted numerous security measures in the effort to fight terrorism and supply chain sabotage. These may be paying dividends in serving as a deterrent to some types of asset misappropriation.

1 Mean number of incidents of economic crime reported in the Transportation and Logistics industry compared to all industries



¹ *Economic crime: people, culture & controls: The 4th biennial Global Economic Crime Survey* is available for download at pwc.com/crimesurvey. The survey is based on interviews with executives responsible for detecting economic fraud in 5428 companies in 40 countries.

² Association of Certified Fraud Examiners (ACFE), *ACFE Report to the Nation on Occupational Fraud & Abuse*, 2006, 4.

At the same time, a lower rate of detection via the internal audit function may suggest that a greater percentage of the more sophisticated asset misappropriation schemes, such as fraudulent disbursements, are actually going undetected. Fraudulent disbursements comprise a wide range of fraud schemes which result in cash being inappropriately sent from the company to another party. The decentralised nature of much of the T&L industry makes it particularly susceptible to this type of economic crime. Examples of fraudulent disbursement schemes include payments to ghost employees, fictitious vendors, pay-and-return schemes, over-billing schemes, unauthorised overtime schemes, and expense report schemes.

Further, T&L companies need to be vigilant about internet security issues, as the breach of passenger or other data can have very serious consequences.

The situation also improved around corruption and bribery, with only 9% of T&L companies reporting incidents, compared to 13% of T&L companies in 2005, and 13% across industries in 2007. The incidence of corruption and bribery

was particularly low in Western Europe at just 3%. Nonetheless, corruption remains a very real issue for the industry. Some areas which may be particularly rife for corruption and bribery in the T&L industry include major building projects, procurement (e.g. airports), appropriate use of rebates and other customer loyalty schemes, and fleet maintenance. Some companies are even taking the threat of incidents seriously enough to exit markets they feel pose too great a risk.

In contrast, accounting fraud was up slightly from 2005. Most segments of the T&L industry are operating within very narrow margins, a situation which can lead to enormous pressure on management to achieve revenue and profit targets, and thus generate the motive for financial statement manipulation which may help achieve these goals. One such type of fraud is revenue leakage, which occurs when there are discrepancies between the quantity of items shipped, and the quantity of items for which revenue is being recognised. This is a very important issue for the transportation industry because, in many cases, companies ship thousands of items per day. Another

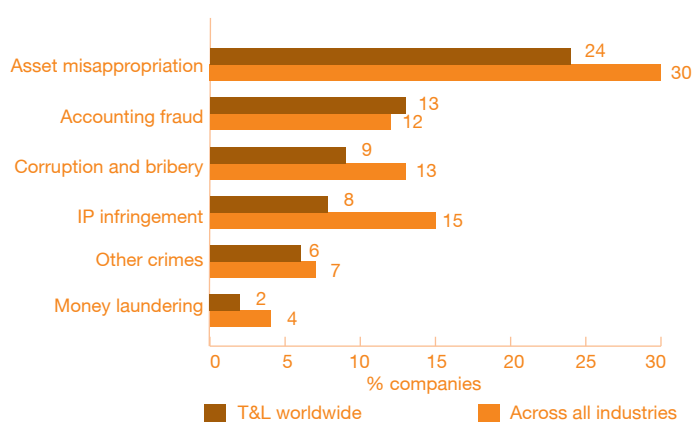
common type of accounting fraud involves manipulating timing estimates on shipments.

And the bad news – incidents of economic crime more costly

While average financial losses in the T&L industry were somewhat lower than the level seen across all industries, the average loss more than quadrupled in comparison to 2005, going from US\$340,000 to US\$1.72 million. This overall figure is probably driven by extremely high losses in certain areas, particularly intellectual property (IP) infringement (US\$3.52 million vs. global all industries: US\$1.90 million). In the T&L industry, IP infringement is most likely to take the form of industrial espionage, so it's not surprising that these incidents may be particularly costly.

Economic crime costs substantially more than the losses directly generated by the crime. Companies also need to consider the costs of managing incidents. In terms of the concrete cost of managing economic crime, T&L companies reported somewhat lower levels of cost than did respondents across all industries.

2 Percentage of companies surveyed reporting different types of economic crime



But economic crime can have a more far-reaching impact that is difficult to measure. Collateral damage can include damage to a company's brand or to its position with regulators. Staff morale may be impacted, with a resultant drop in productivity. Negative publicity from fraud can also affect a company's share price.

T&L respondents seem to be somewhat less aware of these broader impacts of economic crime. Only 39% of those T&L respondents who detailed serious incidents of economic crime reported having suffered collateral damage from the same, in contrast to more than half of companies across all industries (54%). Still, one in ten respondents described the collateral damage suffered as significant. Dealing with major incidents also proved a distraction for management – around 22% of respondents described the impact on management's time as somewhat or very serious, roughly the same rate as across all industries (25%).

Other types of collateral damage that received particular mention from T&L executives included 'damage to company reputation' and 'decline of working morale',

both of which were also highlighted by respondents in our 2005 survey.

The emerging markets

This section takes a look at economic crime risks in the developing markets, including Brazil, China, India, Indonesia, Mexico, Russia and Turkey (a group which PwC terms the 'E7' or 'Emerging Seven').

T&L companies reported a notably below-average rate of fraudulent offences in the E7 region, with less than one-quarter of respondents (22%) reporting an incident of economic crime. Further, the average overall financial losses through economic crime in the E7, while higher than for T&L companies worldwide, were still well below the average across all industries, as were average managing costs.

T&L companies need to be aware of the threat of corruption and bribery in the E7. A large number of T&L respondents for the E7 reported that their company had been asked to pay a bribe (20%). Further, 31% of T&L companies reported that their business had suffered because of corruption by competitors in the E7, so

the incentive to accede to such requests may increase in the future. This response rate was somewhat higher than the global average across all industries (24%) and the average of T&L companies worldwide (21%).

Corporate security measures gain in importance

A closer look at the primary methods of detection of the most serious incidents of economic crime reported by respondents in the T&L industry reveals a somewhat lower rate of detection by chance, either via internal or external tip-offs or by accident (30% vs. 40% across all industries; see figure 3).

This result is particularly driven by a lower rate of detection through external tip-offs. Corporate security measures played a much more important role in the T&L industry than they did in other sectors, with 16% of frauds detected through this mechanism, compared to only 4% of fraud across all industries.

Some of these corporate security measures have been introduced in

T&L companies are having more success detecting economic crime through corporate security measures, however the effectiveness of internal audit has declined

response to international pressure to fight terrorism and supply chain sabotage by ensuring security in ports and airports; logistics service providers have also been obliged to take serious measures to ensure that storage facilities do not provide opportunities to tamper with goods in transit. While these measures represent an additional level of cost for the industry, they may be providing unanticipated benefits as a means of detection of economic crime, and as previously noted, may potentially be serving as a deterrent as well.

In contrast, internal audit detected fewer instances of economic crime in the T&L industry in 2007 – 17%, compared to 25% in 2005. Companies should continuously review their internal audit plans to ensure a balanced approach to fraud detection.

Reporting, investigation, recovery of lost assets

Discovering fraud is only the first step. Companies also need to decide how to deal with the perpetrator, and attempt to recover lost assets.

Upon the discovery of a serious incident of fraud, and consistent with the global results, the most common response of T&L companies was to inform their executive management (67%), albeit notably less frequently than did their peers across all industries (82%). Around 58% also reported fraud to law enforcement, a figure in line with the average across industries. This figure was much higher in Western Europe (71%). Investigation was primarily undertaken internally (e.g. internal audit 58%, in-house counsel 53%). Many companies also chose to call in law enforcement officers (57%, across all industries 50%).

T&L companies are sending some mixed messages in response to serious incidents of economic crime. While criminal charges were pressed more frequently (58% vs. across all industries: 50%), nearly one-fifth of companies chose to do nothing in response to these incidents (19% vs. across all industries: 16%). This response rate is up dramatically from 2005, when only 3% of T&L companies took no action. This trend is cause for concern, as it suggests that companies may be slipping into

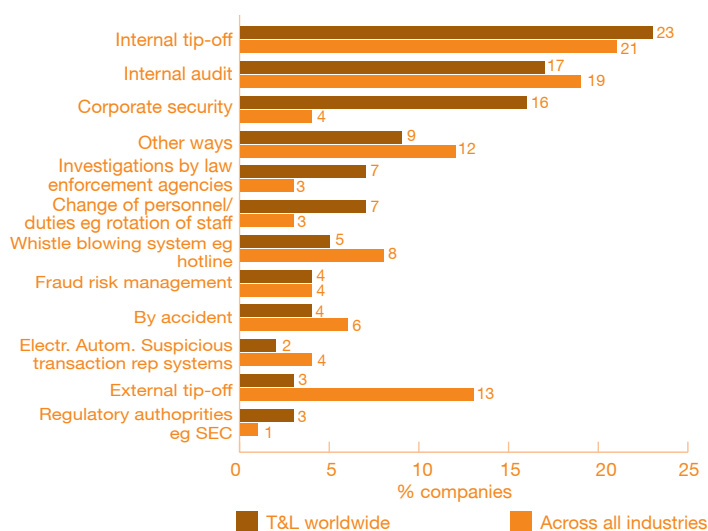
unintended complacency around the risk of economic crime. Companies who do not respond rigorously to incidents of fraud run the risk of encouraging future fraudsters and increasing their future exposure to economic crime.

T&L companies were less likely to recover some of their losses. Only 32% of companies recovered at least some of their losses, down substantially from the 49% rate of recovery seen in the industry in 2005, and well below the 42% average rate across all industries. When T&L companies chose to prosecute, however, they experienced a fairly high rate of success in garnering some restitution. Over nine-tenths (91%) of the companies in this industry who took perpetrators to court reported having recovered at least a part of their losses through court proceedings (across all industries: 62%).

Some success in the courts, but more T&L companies are also doing nothing

Overall, T&L companies reported a similar level of control measures as their peers across all industries. In a few areas,

3 Methods of detection of most serious incidents of economic crime



Note: Categories with response rates of less than 2% have been omitted.

however, T&L companies have been slower to implement some key controls, including whistle-blowing systems (31% vs. across all industries: 42%) and electronic suspicious transaction reporting systems (27% vs. across all industries: 32%). They are also less apt to have instituted frequent specific fraud training (23% vs. across all industries: 30%).

Management awareness: undue optimism?

In the T&L industry, as is the case across all industries, executives are quite optimistic about their chances of avoiding incidents of economic crime in the future. In 2005, only 11% of respondents expected to suffer from incidents in the following two years – but in 2007, 37% of respondents reported that their company was the victim of economic crime in the last 2 years (see figure 4). In 2007, even fewer T&L respondents, 9%, expect their company will be subjected to economic crime in the next 2 years. Chances are high that many of these respondents will have to face a much bleaker picture than they anticipate.

Company culture showing room for improvement

More than half of those committing serious incidents of economic crime in the T&L sector came from within the company, slightly more than the rate across all industries (57% vs. 50% across all industries). A substantial 20% of perpetrators came from the ranks of top/senior management, similar to the rate across all industries (see figure 5). This trend is cause for concern, as our global survey results indicate that fraud by senior managers is much more likely to negatively impact staff morale, particularly when top-ranking perpetrators are seen to have been let off lightly.

Taken together with the sharp increase in T&L companies who choose to do nothing in response to serious incidents, this result suggests room for improvement in setting the appropriate ‘tone at the top’.

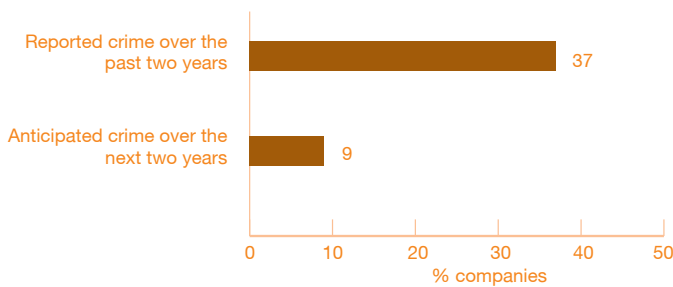
In the overall survey, we noted that a lack of discipline and attention around common areas such as asset misappropriation can be symptomatic of a cultural ambivalence towards correct behaviour that leads to an environment in

which more devastating economic crimes – corrupt acts, participation in cartels, financial statement fraud – can occur. In effect, this is an indication of inadequate culture – and culture is the very thing which provides the best protection against a catastrophic economic crime event.

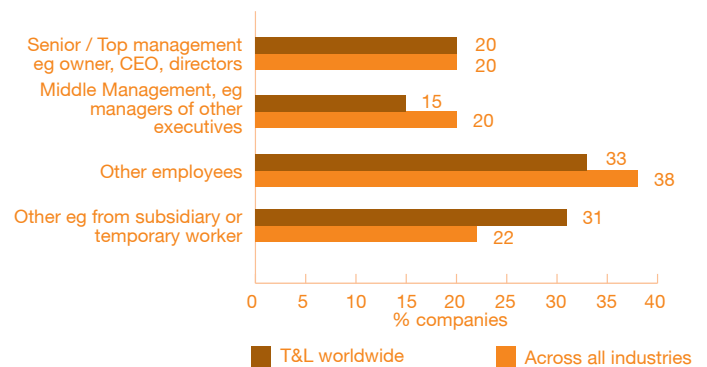
A large proportion of offenders also came from workers at subsidiaries or temporary workers – 31%, compared to 22% across all industries. These offenders may come from the ranks of the many subcontractors working in the industry, particularly in the logistics sector. There is some good news, though. Middle managers in the T&L industry are less likely to commit fraud – only 15% of economic crime was perpetrated by middle management, compared to 20% across all industries.

Overall individual causes of fraud were ranked more highly than corporate causes; some corporate causes sited more frequently by T&L respondents included ‘too great anonymity in the staff/management’, and that ‘ethical codes were not communicated very clearly’. While these results are unsurprising given

4 Perception vs. reality: Actual and anticipated levels of economic crime



5 Level of perpetrator of most serious incidents of economic crime



the widespread use of subcontractors in many segments of the industry, a consistent company culture which includes subcontractors is one critical factor in preventing economic crime. T&L companies need to take a careful look at how they are interacting with staff and ensure that a comprehensive programme of ethics is in place and understood by every member of the organisation – even temporary employees or subcontractors.

Another corporate cause of fraud cited somewhat more frequently by T&L companies is ‘pressing company targets’ – and indeed, the industry faces extreme pressures to maintain narrow margins. Spiralling fuel costs have made the problem even more severe. Companies need to keep planes in the air, get packages delivered on time, and ensure that fleets of trucks are fully loaded, or face losing profitability. These types of situations can add to the incentive to commit fraud.

Outlook and concluding thoughts

Significant corporate changes such as a merger, acquisition, sale or outsourcing

of the company or its businesses, entry into new markets and staff reduction have been shown to increase the risk of economic crime. Respondents in the T&L sector reported a slightly lower rate of change than their peers across all industries, however more than half did experience significant change (at least one change: 52% vs. 55% across all industries).

Mergers and acquisitions have been on the upswing in the industry over the past several years, and this trend looks likely to continue³. As an organisation grows more complicated, enters new markets or integrates new acquisitions, internal control systems may have trouble keeping up. And this in turn can lead to increased opportunity for fraudsters. Executives must acknowledge the risks posed by fraud and take action to minimise their companies’ exposure.

T&L companies have made major strides in their awareness of the significance of economic crime in recent years. Newfound sensitivity led to the adoption of greater control environments in many organisations; further, security measures have necessitated more

stringent oversight of the entire transport and logistics process. These factors may have contributed to the somewhat lower level of economic crime seen in our most recent survey. Nonetheless, T&L executives should guard against unintended complacency. The decrease in detection via internal audit mechanisms and the sharp increase in the number of companies doing nothing in response to serious incidents of economic crime need to be addressed; further, companies should be aware of the impact of fundamental changes in the industry, such as globalisation, on the potential for economic crime in the future.

T&L companies face extreme pressure to maintain narrow margins, which may create incentives for employees or management to commit economic crime

³ For more details, please see PricewaterhouseCoopers’ quarterly series, *Intersections: Global Transportation and Logistics mergers and acquisitions analysis*, available for download at pwc.com/transport

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