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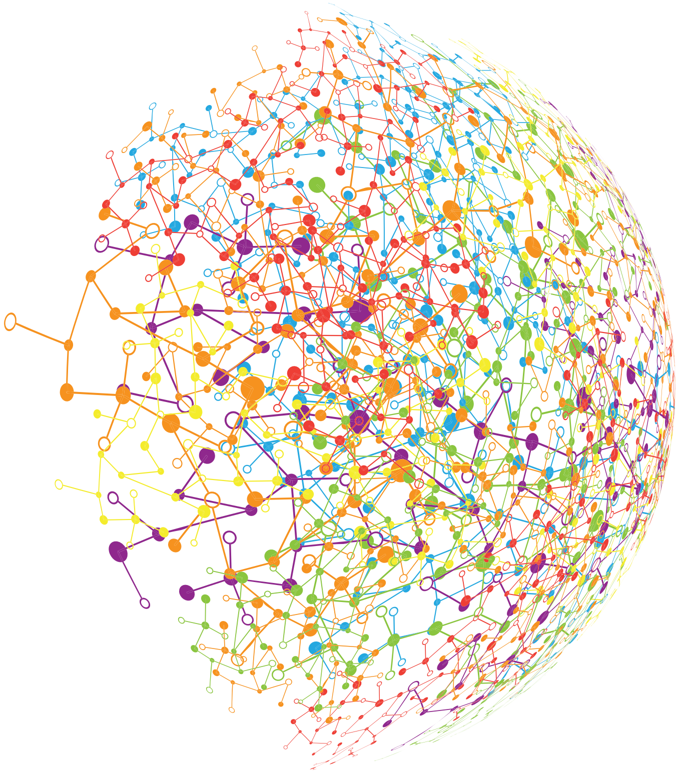

The impact of COVID-19
A changing landscape for fraud and conduct risks

Setting the scene

The outbreak of COVID-19 brought significant and unprecedented operational disruption and uncertainty for businesses. Whilst a limited number of sectors and sub-sectors have seen challenges in meeting spikes in demand alongside disruptions to their supply chain, an overwhelming number of sectors and sub-sectors have faced a complete or near complete reduction in demand through 'lock-down' measures, particularly in Europe and the US. The business community is looking forward now, in terms of the easing and cessation of 'lock-down' measures across the globe, albeit with each country acting individually. There is much reference by commentators to a 'new normal', with social distancing and other protections to remain in place, and with a return to pre-COVID-19 levels of activity and commerce some way off.

Against this background, COVID-19 creates a changing landscape for fraud and conduct risks for businesses operating across all industry sectors. The disruption is creating greater business and personal pressure and hence incentive to commit fraud or misconduct, at the same time as providing greater opportunity to do so.

We discuss the increased exposure to fraud and conduct risk in more detail below, characterising them by reference to the following areas:

- Financial misreporting, as may be seen in the exaggeration of financial performance and balance sheet strength through accounting manipulation;
- The misappropriation or extraction of funds (and data) from a business, whether through theft, fraud or external attack; and
- Misconduct by agents, employees, management and directors with the intention to create an advantage for a business (and possibly the individuals concerned), with a traditional area being bribery and corruption and now, in the COVID-19 environment, access to government financial support presenting an additional risk area.

Fraud and misconduct risk areas will be anticipated in the control frameworks (including fraud response plans) that exist within businesses. However, those frameworks and plans pre-date COVID-19 and will now need to be re-assessed, adapted and enhanced as businesses and economies across the globe emerge from the immediate aftermath of the COVID-19 pandemic.
In addition to the pandemic, the heightened scrutiny on the management of fraud risk, as illustrated by the Brydon review recommendations, is a further strong rationale for senior management and boards to reassess fraud risk.

The responsibilities on management and the directors

It is well-established that the primary responsibility for the prevention and detection of fraud (in its widest sense) rests with those charged with the governance of an entity and senior management. In the UK, this responsibility is, for example, expressly recognised and set out within paragraph 4 of International Standard on Auditing 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements. This aligns with the overarching board responsibility from Code Principle C of the UK Corporate Governance Code, which states that the board should establish a framework of prudent and effective controls, which enable risk to be assessed and managed.

In addition, in his December 2019 report on audit quality and effectiveness in the UK, Sir Donald Brydon recommended:

- A new reporting duty on directors to report on the actions they have taken each year to prevent and detect material fraud against the background of their fraud risk assessment; and
- A corresponding new duty on the auditor to state explicitly in their report the work they have performed to conclude whether the directors' statement on material fraud is appropriate, and what steps they have taken to assess the effectiveness of the relevant controls and to detect any such fraud.

These recommendations have not yet taken legal or regulatory form, but nonetheless they are indicative of a higher level of expectation on management and directors of a business.

In this context, it is worth also acknowledging the responsibilities of auditors, and their role in financial reporting, with audits needing to address the impact of COVID-19 in the context of company and group audits. Management and boards should begin to anticipate and be ready to respond to auditors bringing a fresh lens to their enquiries regarding their assessment that the financial statements may be materially misstated due to fraud, and their response to these risks and, in particular, their evaluation of the business' fraud-related control processes.

Changing risks: financial misreporting

There will be various motivations to manipulate and inappropriately influence accounting and financial information as a consequence of COVID-19 in order to paint results and balance sheets, and financial forecasts, in a more favourable light, whether it be to assist in supporting a going concern assessment, to assist in a capital raising, to avoid breaching loan covenants, or perhaps for mere personal gain.

Where financial and management information is reported, it is essential that it is free from manipulation. This heightened risk comes at a time when disruption and changed working patterns may impact normal approval and oversight processes increasing the risk of override. In particular, those responsible for overseeing financial reporting should pay close attention to areas which require a greater degree of judgement, such as revenue recognition, asset valuations, capitalisation of costs, impairment of goodwill, inventory and bad debt provisioning, or valuations of long term contracts. There will be added complexity when a business has multiple and diverse operations, and those operations span differing geographical territories. Further, those responsible for oversight should also be alert for the risk of past issues that negatively impact results being accounted for now in order to hide them within the general downturn in business.

From an oversight and governance perspective, reinforcing and monitoring adherence to the business' accounting policies and practices will be important, as will early sight and communication with senior management and the board of judgement areas which have the potential to be significant in the context of market updates and financial reporting.

With regard to future forecasts to support going concern assessments, it will be important for key assumptions to be robust, 'stress tested' for various scenarios and free from bias, and for there to be alignment with information shared with the business' lender community.

Changing risks: misappropriation or extraction of funds and data

As economies begin to reactivate and businesses begin to transact again, then the re-commencement of trade with suppliers will create opportunity for the misappropriation or extraction of funds. Financial pressures on individual employees may prove to be a trigger for internal fraud, possibly in collaboration with existing or new suppliers looking to re-build revenues and where financial inducements to employees may be 'built-into' supply prices and hence not readily visible to management within the business.

COVID-19 has seen many businesses move to remote working, with the prospect that this will continue for several months. Further, headcount reductions, or continued absences, may impact on capacity internally and the ability to execute normal control processes and procedures. Businesses will therefore need to be alive to vulnerabilities or gaps emerging in key areas of controls, for example, the approval of new suppliers and their terms, the approval of purchase transactions, segregation of duties, the extent and quality of documentation requirements to support transactions, system access rights for employees and IT controls, including surrounding remote access to business systems, with controls needed to make sure only the right people are accessing the right systems.

Expense and payrolls frauds will be another area of vulnerability. Further, management should remain alert for existing fraud schemes that are now more likely to come to light as they can no longer be hidden due to financial or operational reasons.

There is also an inevitable heightened external threat through targeting by criminals, including through cyber attacks looking to penetrate business' data systems and extract or amend sensitive data.

Changing risk: bribery and corruption

With re-commencement and re-build of trade following COVID-19, for many businesses there will be significant pressure on sales teams to regain and win new contracts and sales orders. Where this is the case, senior management and the board will need to ensure that the business' (and their agents') sales practices are not at risk of falling foul of global anti-bribery legislation. In doing so, it is important that businesses revisit their existing ABC framework to ensure that they have necessary and appropriate controls and procedures in place, refresh knowledge and awareness through training, monitor risk areas on an ongoing basis and use clear messaging that demonstrates the right 'tone from the top'. Further, monitoring such areas as agency arrangements and fees, notably in overseas territories, will be of renewed importance.

Changing risk: misconduct in seeking government financial support

Never before have governments around the world made as much financial support available in such a short timeframe. With businesses under significant pressure, and converse to financial misreporting risks, there may be a temptation for businesses to exaggerate their need or qualification in order to obtain government financial support. Such instances can have serious consequences for a business, its management and the board, so it is essential that when a business does apply for such financial support, it does so in an entirely transparent manner and without misrepresenting its financial position in any way within financial analysis and projections or supporting commentary. Further, monitoring the use and application of any government support, potentially in anticipation of post-award 'audit' style reviews, would be appropriate measures to put in place. The consequences of a public recovery action against a business may give rise to regulatory action, significant reputational and financial damage, and even disbarment from tendering for public sector contracts.

Conclusion

The continued disruption caused by COVID-19 has increased the inherent risk of fraud across all business sectors and the enhanced scrutiny on management provides a compelling rationale for management and boards to revisit and refresh existing fraud risk assessments to ensure they remain fit for purpose. It is vital that new risks are identified and existing risks reassessed, control processes are refined, adapted and reinforced and effective monitoring is deployed.

If you would like to discuss the topics covered by this paper with us, please contact Jules Colborne-Baber, Simon Cuerden, or James Meadowcroft.

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