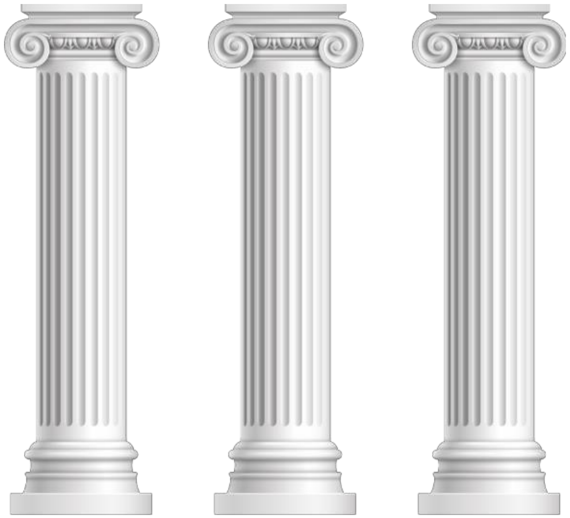
Business & Management



Five key questions all boards should ask about fraud

16 OCTOBER 2019

The webinar will begin shortly…

Business & Management

20 minute webinar: Five key questions all boards should ask about fraud

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Director, Fraud Advisory Panel

FRAUD ADVISORY PANEL

Webinar

Five key questions all boards should ask about fraud

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Wednesday 16 October 2019

Agenda

- My background
- Fraud statistics
- The five questions

Fraud statistics

- No shortage of statistics on this.
- One study estimates that fraud costs businesses and individuals:
  - £130 billion each year in the UK
  - £3.89 trillion each year globally
  - with losses rising by 56% in the past decade [1]
- There are many types of fraud – and they are all managed differently.
- This number likely only includes the amount of the actual fraud and does not consider other costs including:
  - Legal fees
  - Investigation costs
  - Share price drops which leads to a decrease in company value
  - Remediation costs to fix the issues identified
  - Action against Directors of the company – both civil and criminal charges.
- Therefore, Boards need to be asking about – and understanding – the fraud risks and losses in their businesses.

[1] Source: 2019 The Financial Cost of Fraud Report, Crowe, in conjunction with the Centre for Counter Fraud Studies at the University of Portsmouth

Question 1

What is the organisation’s fraud strategy?

- Fraud risk appetite

- Strategy should include the following components:
  - prevention
  - detection
  - deterrence
  - Incident response and investigation

- If it exists, how is its effectiveness measured?

Question 2

Does the organisation have an up-to-date Fraud Risk Assessment?

- A fraud risk assessment is the cornerstone of a robust fraud risk management framework
- Should align to the Fraud Risk Appetite
- Should be updated at least annually but when there is a material change to the business
- This is not solely Compliance and/or Risk's responsibility
  - Have seen that Senior Management awareness of inherent risk exposure and controls environment is limited

Question 3

How does the organisation monitor and detect fraud?

- Fraud can be monitored by systems or other controls

- Monitoring should cover the largest risks

- When detected, there should be a process for:
  - Investigating
  - Reporting – internally and externally
  - Escalating
  - Remediating any root causes

- Whistleblowing reports and customer complaints can be useful indictors

Question 4

What are the key drivers in the business and at our competitors which are influencing our financial results?

- Business environment trends will influence the financial results

- Any unexpected trends in the results such as an increase in sales as the economy is entering a recession should be fully explained by Senior Management

- Important to compare the financial results to those of competitors
  - Understand reasons for differences
  - Question whether your organisation is truly an outlier

- Don’t only question bad results – question the GOOD ones. When it seems too good to be true….

Question 5

What is the culture in the organisation?

People build controls to stop people doing the wrong thing. What they need to do is create an environment that makes it easier for people to do the right thing. That's how you build sustainable performance.

- Traditionally organisations rely on compliance and controls, yet corporate failures still occur
- Recognising the role culture has played in numerous high profile transgressions, regulators have demanded more robust monitoring of culture. Expectations that are mirrored by investors, boards and other stakeholders

Corporate failures

Stakeholder expectations

Regulatory viewpoints

- The Financial Reporting Council's July 2016 report, "Corporate Culture and the Role of Boards," - boards are responsible for shaping, overseeing and monitoring culture, and for holding the executive to account

- The "2018 UK Corporate Governance Code' requires boards to monitor and assess culture and satisfy themselves that behaviour throughout the business is in line with the company's values

- The Institute of Business Ethics (IBE's) latest Board Briefing – "Culture Indicators: understanding corporate behaviour"

MetroBank: what went wrong?

MetroBank (2018) – miscategorisation of loans

- Aggressive growth policy – opening new branches whilst established rivals are closing theirs.
- Rapid expansion has been fuelled by capital injections from shareholders. In the summer of 2018, £300m of finance was raised in this way.

Issues identified

- In January 2019, the bank confessed to a major blunder in how it classified its risk weighted assets.
- 10% of the £14.5bn loan book was incorrectly weighted. Commercial property loans were assigned a 50% risk weighting, and commercial buy-to-let loans a 35% weighting, when both should have been 100%.
- Risky assets were therefore undervalued by £900m, and MetroBank missed capital adequacy targets. To meet them, a further £350m of equity was sought from shareholders.
- The error was uncovered by the PRA, but MetroBank originally claimed they had discovered it themselves.
- Share price fell 39% after the announcement, and had fallen a further 12% before the week was out.
- Share price had fallen to £7 per share at the end of May 2019, down from £40 in March 2018.
- Despite media speculation and the threat of legal action from shareholders, no senior executives have had to resign as a result of the incident.
- The PRA and FCA investigations continue.

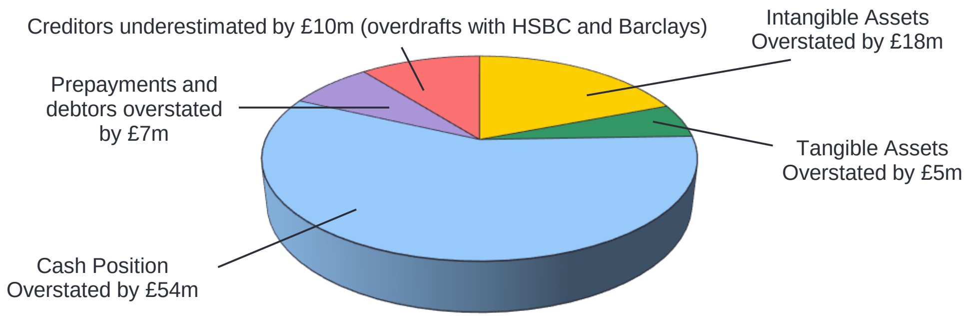
Patisserie Valerie: what went wrong?

Patisserie Valerie (2018) – fraud and collusion concealed by aggressive growth

- HMRC filed a winding-up petition against Patisserie Valerie in September 2018, for unpaid taxes.
- The company ask PwC to investigate the issue, they immediately report *“Significant, and potentially fraudulent, accounting irregularities” leading to a “potentially material misstatement”*. The Finance Director Chris Marsh is suspended, and arrested. The SFO open an investigation into the FD, and five other members of staff.
- The FRC investigate the auditors, Grant Thornton.

Issues identified

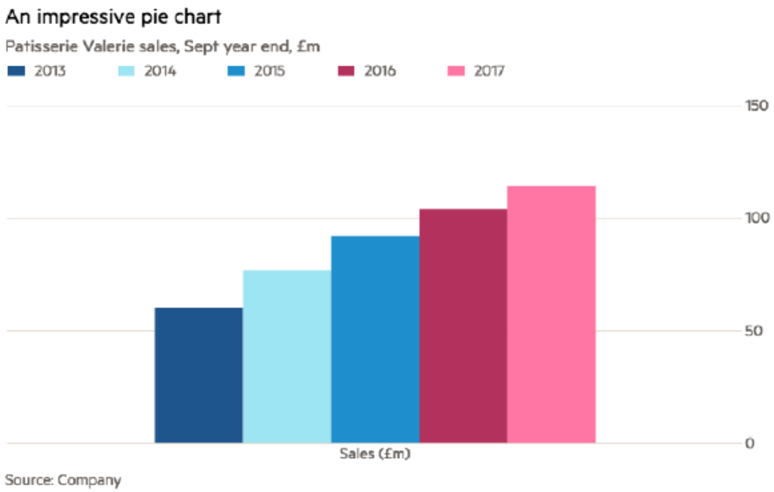
- PwC interim investigation finds *“Thousands of false entries into the company’s ledgers”* and that *“Cash flow and profitability of the business had been overstated in the past”.*
- Undisclosed use of overdrafts of £9.7m from Barclays and HSBC: *“forged company minutes used to take out overdrafts”.*
- Award of undisclosed share options worth £1.7m to senior management.
- £94m blackhole identified:

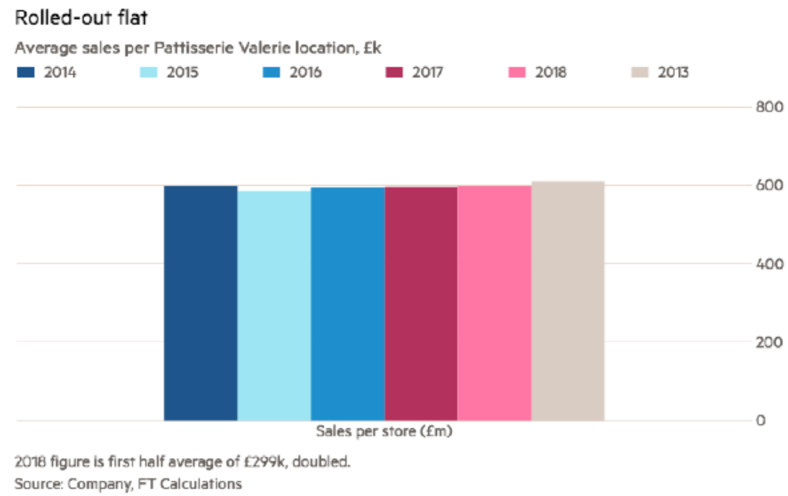


Patisserie Valerie: red flags

What were the red-flags?

- **Sales increase from £60m to £114m**, new stores opening but sales per store remaining static – is this realistic?





- Property lease commitments £61.6m in 2014, increased to only £63.6m in 2016 despite 36 more stores.
- Operating profit margin above similar competitors: 18% compared to Greggs (8%), Costa (12%), Pret (11%).
- Payments to suppliers average 120 days, compared to group policy of 45 days.
- Non-payment of VAT bills between £10m-£12m.

Tesco: what went wrong?

Tesco (2014) – accounting fraud revealed by a whistle-blower

- Tesco overstated its profits for the first half of the 2014 by £263m.
- Shares tumbled to an 11 year low, wiping out almost £2bn from Tesco's value.
- The Serious Fraud Office (SFO) entered into a Deferred Prosecution Agreement (DPA) with Tesco in April 2017 and Tesco agreed to pay a fine of £129m.
- The former Tesco executives have been formally cleared by SFO from fraud charges.

Issues identified:

The Tesco scandal highlights again the perils and pressures of being a publicly traded company with a focus on the short-term performance to "attract" market attention:

- Buyers were motivated to use "rebates" from suppliers – these were treated as additional income.
- Rebates occur when suppliers meet certain sales targets, or if suppliers are part of special promotions.
- Tesco was too ambitious in forecasting these rebates which were manipulated to enhance income and meet sales targets.
- Some employees, realising that rebate sales targets would not be met, offered benefits in the next accounting period in exchange for the rebate payments.
- In the worst-case scenario involved Tesco actually paying money back to the supplier in the next accounting period.

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Tesco: weak corporate governance and controls

Missed red flags:

- Despite increased market pressure from cut-price supermarkets like Aldi and Lidl, Tesco were still forecasting large profits.
- Senior staff at Tesco were highly incentivised to meet targets.
- Tesco supplier management had substantial power to negotiate commercial deals without any oversight from the Finance Department.
- In 2012 a former CFO had sent an internal email warning employees about weaknesses in the company's financial controls after a problem was discovered in its Polish business.
- In 2015 L'Oreal was known to have disputed commercial income of £1m which Tesco was demanding. There was tension from the business to keep profits high by reversing the decline in profits and sales.

Market Capitalisation (Oct 2013 – Oct 2014)

Source: Bloomberg

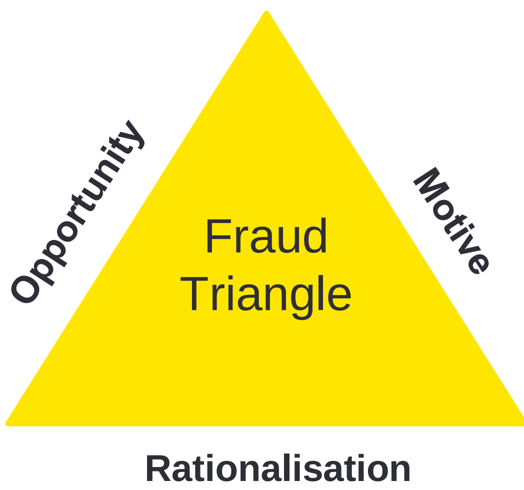
Why did the fraud remain undetected?

- During the 2013/14 audit, PwC had noted the inherent "risk of manipulation" in the estimates of commercial income, which have a big influence on profits. Tesco Senior Management and the Audit Committee had subsequently concluded that this is a "no problem" area.
- It would appear that pressure from management to keep profits high stifled concerns over abuse of rebates.

Common themes

- Red flags indicating that something is wrong are often there to be seen – but is anyone looking for them?
- Controls either fail or are too weak to be considered fit for purpose.
- Many senior executives are focused on investors and market analysis, and not on customers or the longer-term business requirements and direction.

Other red flags



- Tone from the top weak on integrity and / or transparency
- Overly trusted individuals
- Aggressive business attitude
- Overcomplicated business model/ structure

- Profits not realised in cash
- High staff turnover
- Unusual business patterns – value, timing, counterparties
- Overly complex transactions and accounting

- Use of manual journals, suspense accounts
- Swings in provisions and reserves
- Delay, superficial rolled forward reconciliations
- Inventory adjustments / non routine entries in intercompany accounts

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