Checks and Balances Are Critical in the Covid-19 Era

Risk of Fraud Heightened by Aspects of Current Working Life

The severe economic and social impacts of COVID-19 have increased the likelihood of fraud, in relation to not just government assistance schemes where false claims could be made, but also the risks faced by companies and other organisations that may be subject to fraud as a result of the new working environment. With staff generally working from home and many businesses operating with a reduced workforce, either through furlough or as a result of illness, businesses are grappling with operational, procedural and staff changes that could open avenues for fraud. Now more than ever it is important that firms adapt and maintain the required checks and balances which can help prevent falling victim to some form of fraud.

Fraud can be "extractive", in that people claim or take money they are not entitled to, or "non-extractive", which can arise through people wanting to report better results than actual or hide things that they cannot explain. This latter type can be done to present a better picture to shareholders, lenders, potential acquirers and other stakeholders or just to save face.

The response to the current crisis has included huge changes to the working environment as a result of a move to home working and a reduced workforce. This will result generally in changes to operations, procedures or people that might provide opportunities for fraud. Reasons for extractive fraud may include:

- Households may come under increased financial pressure with people out of work or furloughed and not earning full salaries.

- Spending time indoors during lockdown could increase the risk of gambling and the need to pay gambling debts.

Temptation or new opportunities could give rise to increased motivation to commit fraud, and fraudsters may rationalise what they are doing—perhaps to save their families. The financial crisis in 2008 reportedly saw an increase in middle management committing fraud to maintain their standards of living—including keeping up with their children's school fees and maintaining the ability to go on holiday—when their bonuses fell, jobs were lost and wages stopped rising. Under such pressures, people may intend to "borrow" funds and may pay them back initially. Some may have the urge to "borrow" again. This can lead to a dangerous fraud spiral, where those who do not get discovered continue their "borrowing" practices to the point where it is impossible to repay the debt.

Against this backdrop, businesses should be mindful of risks and ensure that they maintain adequate checks and balances to try and protect against fraud. Larger businesses that maintain a risk register may want to revisit it in the current environment.

Checks and balances are put in place to ensure that adequate segregation of incompatible duties is maintained and to avoid unpleasant surprises. Checks and balances could include:

- Create and update controls to ensure transactions are recorded accurately.
- Assign more experienced staff to review work.
- Have someone independent of the preparer review reconciliations.
- Appropriate senior levels approve expenditures.

Larger corporates often have an "Accounting Procedures Manual" which sets out controls and checks to ensure a secure environment for maintaining accurate accounting records. However, changes in working arrangements may have interrupted their operations as a result of:

- Controls or routine procedures being overlooked through team changes.
- Controls being relaxed, and alternative checks not being put in place, as the risks are not fully understood.
- Inexperienced staff being reluctant to admit their limitations or to highlight an issue they don't understand for fear of losing their job or promotion or not being treated seriously.

The regular reconciliation of bank accounts and other key control accounts are important. A further example is in inventory which is often subject to routine physical counting. This is then reconciled to the stock records, and differences are followed up on a timely basis. In turn, these stock records may need to be reconciled to the general ledger or accounting records. Differences can arise for many reasons: poor recording of movements, price changes not properly reflected or human error. If these key reconciliations are not performed on a timely basis, differences can arise and a "black hole" can appear in the accounting records.

Comparing results and looking at variances to flag unusual trends, transactions or balances may not work in an environment which has fundamentally changed over a matter of weeks. Reconciling subsequently can require additional experienced resource to assist in this "catch up", or differences may arise which cannot be explained and require "write off". These unpleasant surprises can surface during a year-end audit or due diligence, through warranty claims or further structural or staff changes, or in the subsequent implementation of checks and balances.

The need to restate results can happen in more stable times, but the current lockdown brings a heightened risk of this. Discovering bad news can result in downgrading, breach of covenants, claims or company failure.

With the considerable disruption to the economy and businesses alike recently, it is easy to forget or overlook the importance of controls, but those checks and balances are there for a reason. If there are changes to staff, operations or procedures, firms must consider whether the control environment is adequate. Firms should consider what mitigation or checks can be put in place to counter increased risk. Failing to take appropriate steps in reaction to such changes in environment increases greatly the chance of fraud or errors occurring, whether intentional or not.

Philip Crooks

Managing Director
pcrooks@thinkbrg.com
M 07710371346