UK Corporate Reform

Proposed new legislated requirements for fraud risk management

Building a better working world

UK CORPORATE REFORM

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Successive corporate failures due to fraud have led to proposed reforms to tackle fraud

Tackling fraud – the next wave of change

In the wake of successive corporate failures, public confidence in the credibility of corporate reporting has been shaken. Consequently, the corporate governance of companies has come under increased scrutiny by regulators, investors, and broader society.

The UK's Bribery Act 2010 pioneered the corporate "failure to prevent" offence to hold companies accountable for failing to prevent bribery. Since then, there have been successive corporate failures due to fraud that have led the UK's Department for Business Energy and Industrial Strategy (BEIS) to announce that they will legislate directors' requirements to report on fraud.

Further, the Law Commission sought views on extending the "failure to prevent" offence to other economic crimes, including fraud. A paper was published on 10 June 2022 that sets out detailed options for reform and concluded that any extension of the "failure to prevent" offence should include fraud as a minimum. This may result in legislation to prosecute companies for failing to prevent "fraud by an associated person such as an employee or agent".

The impact of these reforms means that companies will need to implement, maintain, and report on the procedures they have in place to prevent and detect fraud.

New legislation recommended to prosecute companies for failing to prevent fraud by an associated person such as an employee or agent

What are the new requirements?

Directors of PIE companies to report on the steps they have taken to prevent and detect material fraud

Based on the BEIS response on 31 May 2022, to reinforce directors' responsibility for fraud prevention and detection, the Government is intending to legislate the need for directors of Public Interest Entity (PIE) companies to report on the steps they have taken to prevent and detect material fraud. The definition of a PIE will be expanded to include companies which have revenues of £750 million and 750 employees or above. This means that some of the UK's largest private and AIM-listed companies will be required to comply with the reporting requirements.

Whilst the BEIS response does not set out what the specific steps should be, the consultation stated that such "actions may include undertaking an appropriate fraud risk assessment and responding appropriately to identified risks; promoting an appropriate corporate culture and corporate values; and ensuring appropriate controls are in place and operating effectively".

Some of the UK's largest private and AIM-listed companies will be required to comply with the reporting requirements

BEIS does not define materiality however, it does state that "the types of 'fraud' that directors are required to report on should be those most relevant and important to investors". In our experience, companies will need to consider financial, legal, and reputational impacts when defining materiality related to fraud risk.

Further, whilst the Government is not yet proposing to place new obligations on the auditors over the directors' fraud statement, auditors are required to comply with the recent revisions to ISA 240 to explain the work that they have done to detect fraud and assess the effectiveness of relevant fraud controls. In addition, under ISA 720, auditors are required to read and consider "other information" in the financial accounts to identify whether it is materially inconsistent with the financial statements or knowledge obtained during the audit or materially misstated in the context of legal or regulatory requirements.

As a result, companies will likely be under increased scrutiny by auditors and broader stakeholders to evidence how they manage fraud risk within their organisation.

NEW REQUIREMENTS

What is fraud?

Whilst there is no single definition of fraud, the Association of Certified Fraud Examiners (ACFE) defines fraud as "any intentional or deliberate act to deprive another of property or money by guile, deception, or other unfair means". Given that several of the recent corporate failures involved fraudulent financial reporting, and as suggested by the Audit Committee Chairs' Independent Forum (ACCIF) on our recent webcast[1], it will be a key focus for the Government, investors, and broader stakeholders. However, fraud may also include non-financial reporting[2], asset misappropriation and corruption.

[1] The Government's response to reforming audit and corporate governance – What has changed and what that means for UK business, 6 June 2022

[2] Non-financial reporting refers to transparency reporting where businesses formally disclose certain information not related to their finances, including information on non-financial key performance indicators and environmental impact

13%

According to EY's 2022 Global Integrity Report, levels of fraud and unethical behaviour remain high with 13% of companies confirming that they have experienced a significant fraud within the last 18 months.

Why does fraud risk remain a significant threat to your business?

Levels of fraud and unethical behaviour remain high with 13% of companies confirming that they have experienced a significant fraud within the last 18 months[3]. The current level of market volatility, supply chain pressure, and high inflation is increasing the cost of doing business and putting ever more pressure on companies to hit growth targets. This, combined with increased economic pressure on individuals' finances from the cost-of-living crisis, further fuels the incentives to perpetrate fraud. To protect stakeholders and keep up with new regulatory developments, a robust fraud risk management framework is fast becoming a critical element of corporate governance.

FRAUD RISK MANAGEMENT

[3] EY Global Integrity Report 2022

Overcoming the challenges of complying with new regulations

75%

75% of companies that we have recently worked with lacked clear ownership and accountability for the delivery and oversight of their fraud risk management programmes.

Internal controls over both financial and environmental, social and governance (ESG) reporting, are a core component of any fraud risk management framework, and therefore essential when directors of PIEs report on the steps taken to prevent and detect material fraud. Our research suggests that 65 of the FTSE100 companies have already implemented more rigorous Internal Controls over Financial Reporting (ICFR) frameworks or have begun projects to explore doing so.

Whilst our research indicates that 42 of the FTSE100 companies commented in their most recent annual reports on the steps they are taking to address the recommendations set out in the consultation document, very few specifically commented on actions being taken to respond to the proposals regarding fraud prevention and detection. Most (93) companies have reported on specific types of fraud risk such as misappropriation through cyber-attack or corruption however, only four companies reported fraud risk as a significant risk to the business.

Before the Government's response, many companies had already started to move in the right direction but are facing several key challenges to understanding and mitigating their fraud risk. Some of the common challenges we are seeing across companies include:

- **Misunderstanding of fraud and potential grey areas**

  Whilst awareness of ethical issues such as bribery and corruption and the emphasis on business integrity has grown in recent years, fraud as a specific risk is often not front of mind. Employees and third parties may not be aware of how the organisation defines fraud, the different ways fraud can be perpetrated in the organisation and how to navigate potential grey areas. In our experience, most employees understand that asset misappropriation is fraud. However, financial reporting fraud, such as manipulating accruals to smooth profits between years and ensure targets are hit, is seen as more of a grey area that is common practice to manage business performance, rather than an act of fraud.

- **Siloed or uncoordinated approach to fraud risk management**

  75% of companies that we have recently worked with lacked clear ownership and accountability for the delivery and oversight of their fraud risk management programmes. Companies tend to focus on one or two areas of their fraud risk management framework in isolation without considering all the elements and how they work together. Without an integrated and cohesive end-to-end fraud risk management framework, there is increased fraud risk exposure.

- **Inadequate understanding of fraud risk exposure across the organisation**

  A fraud risk assessment (FRA) forms the foundation of an effective fraud risk management framework and is the key first step for all companies. We often see that companies fail to appropriately conduct comprehensive fraud risk assessments as they are unaware of how fraud risk might materialise in the context of their operations.

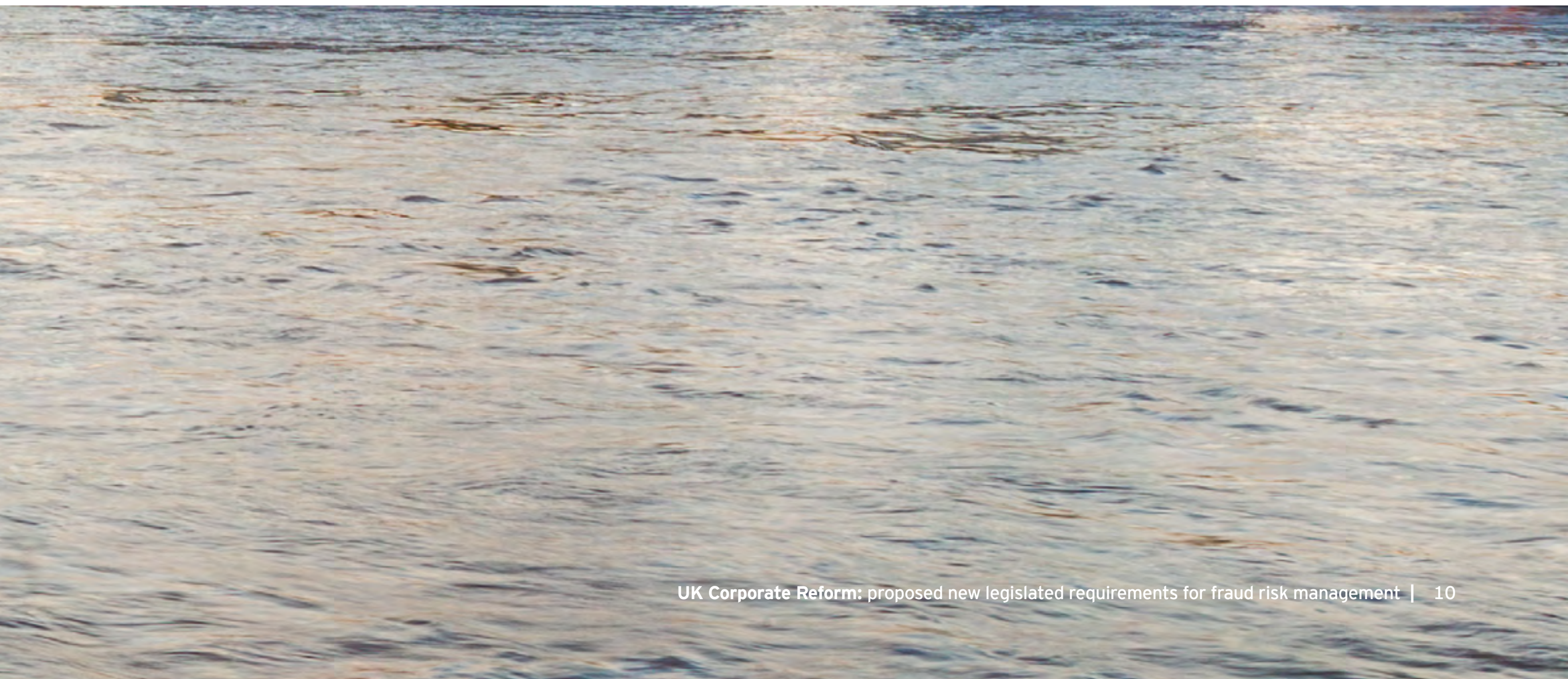
  Organisations have also encountered pitfalls when they try to reverse engineer the FRA process by mapping existing internal controls to better-known fraud risks without considering their fraud risk landscape. This results in a lack of understanding of the fraud risks and inadequate processes and controls that prevent, detect, and respond to fraud risk.

- **Lack of effective fraud detection activities**

  Whilst strong internal controls will be a company's first line of defence, fraud can be perpetrated by collusion and circumvention of controls. Therefore, measures to detect fraud must also be strong. Many organisations perform little or no review or monitoring of their controls or activities to detect fraud.

  When monitoring is undertaken, most companies do not leverage their data to identify high-risk indicators such as approval patterns, bank detail changes, and one-time vendors, which can detect fraud. This results in undetected and unresolved fraud risks and issues that could have been prevented.

To provide confidence to stakeholders, and to keep up with competitors, changes in regulation, and expectations of enforcement agencies, companies should consider how they will overcome these challenges.




PIZZA EXPRESS

GETTING AHEAD

Getting ahead of regulatory change

When considering a company's fraud risk management framework, those charged with governance should ask themselves these five key questions.

Many organisations that we have worked with recently found that performing a current state assessment of their existing fraud risk management framework has enabled them to bring existing elements together, identify gaps and prioritise areas for improvement. It has also enabled them to manage the questions and expectations of key stakeholders. In addition, our current state assessment provides a clear roadmap that helps to ensure that directors are comfortable making the required statements once the legislation is passed and effective.

Five key questions for directors

1. Do you have a clear definition of fraud, and expectations of your employees and third parties to ensure issues are raised to you in confidence?
2. Who is accountable for managing fraud risk and are there clear responsibilities for individuals across your organisation?
3. Have you recently conducted a fraud risk assessment which:
   - Identifies where you are susceptible to fraud risk
   - Assesses the likelihood and impact of the fraud risks; and
   - Identifies and assesses the controls in place to mitigate the fraud risk
4. What processes are in place within your organisation to detect instances of fraud and how is data used to enable timely detection?
5. What information and metrics are used to evidence that your fraud risk management framework is operating effectively?

EY contacts

Emma Browne
Partner, Forensics
+44 7771 808 428
ebrowne@uk.ey.com

Terry Seagreaves
Associate Partner, Forensics
+44 7799 433 943
tseagreaves@uk.ey.com

Kar-Wai Hau
Assistant Director, Forensics
+44 7552 271 053
khau1@uk.ey.com

James Hensser
Assistant Director, Forensics
+44 7880 487 707
jhensser@uk.ey.com

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