Whenever an organisation transacts with a third party there may be a risk of being exposed to financial and reputational losses resulting from fraudulent conduct or unethical behaviour. This guide explains how to conduct basic **due diligence on UK-based third parties.**

INBRIEF

A BEGINNER'S GUIDE TO ANTI-FRAUD MEASURES | DECEMBER 2015

FRAUD ADVISORY PANEL

Due diligence on UK-based third parties

WHAT IS DUE DILIGENCE?

Due diligence is the process of undertaking an enquiry into a third party (such as a customer, supplier, agent or outsourcer) to ascertain any risks that may arise in transacting or dealing with that particular party.

Due diligence is more than simply obtaining documentary or electronic evidence of a customer or supplier's identity and proof of address. It is about *understanding* the nature of the third party's business and your relationship with them.

WHY IS IT IMPORTANT?

Conducting due diligence is important to help protect against losses due to fraud, reputational damage (through dealing with undesirable third parties) and credit risk. Effective due diligence serves as a line of defence against these risks and can frustrate efforts by those with dishonest intent. It should form part of your fraud prevention strategy.

It is important to note that some professions and sectors are required to conduct due diligence as part of the UK anti-money laundering regime and should follow the guidance issued by their trade or professional body and/or regulator.

WHO IS RESPONSIBLE?

The more people involved in the due diligence process, the more likely it is to be effective. Duties are usually divided to ensure that no one individual is responsible for the entire due diligence process from start to finish.

- Directors and/or trustees (in the case of charities): due diligence strategy and the policy and procedures which underpin it.
- Managers and employees (in different departments): performance of due diligence enquiries with a separate member of staff making the final decision whether to enter into a relationship.
- Internal audit: independent assurance on the effectiveness of the controls put in place to manage the risk of fraud.

KEY ELEMENTS OF EFFECTIVE DUE DILIGENCE

It is most important to have a written policy on due diligence. It should set out:

- the enquiries that will be conducted and who will perform them;
- the person(s) with final decision-making authority on whether to transact with a third party;
- how information will be retained and for how long;
- any industry, statutory or regulatory obligations that need to be complied with;
- the frequency of ongoing monitoring; and
- the frequency of relationship and agreement reviews.

It should also set out the types of negative information that might result in more specific enquiries or a refusal to transact or deal with a particular party.

It is essential to ensure that the policies or procedures implemented are practical and fit for purpose.

WHO SHOULD BE SUBJECTED TO DUE DILIGENCE?

It is good practice to check each and every customer, supplier or other third party that may support your business (eg, a sales agent or outsourcer). The process should be applied consistently as part of 'business as usual' procedures, regardless of the nature of the business relationship, and not be seen as an optional 'bolt-on'. A basic standardised form for staff to use can help do this.

However, a risk-based approach may be more appropriate if the number of third parties is high. For example, companies with turnover, balance sheet or headcount of a certain size, will only be subject to a small range of enquiries. In contrast, those operating in what are perceived to be 'high risk' fraud and/or corruption markets or business sectors, or because they are smaller, may be subject to a greater number of enquiries.

WHEN SHOULD DUE DILIGENCE CHECKS BE PERFORMED?

Due diligence should be viewed as an ongoing process rather than as a 'one-off' check.

The most obvious time to perform due diligence checks is before you conduct business with a third party for the first time – even if they have been introduced by a trusted individual or organisation.

The second, less obvious, time is when any changes are made to high-risk transactional areas such as details of supplier bank accounts or customer addresses – regardless of the length of the relationship. This is because a fraudster may try to intercept payments or goods by impersonating a legitimate person or organisation.

Be vigilant for 'bust-out fraud' where a firm of apparent good character works with you for a while, builds up trust and a line of credit then suddenly disappears without making payment. This can sometimes be detected by checking that the entities actually exist and have strong relationships with other organisations such as banks or insurers.

WHAT TYPES OF ENQUIRIES SHOULD BE CONDUCTED?

There are a variety of useful sources that you can use as part of due diligence checks.

The internet
A simple search of the internet using any search engine is most common. It is important to use different search strings and to go beyond the first page of the results as information is sometimes pushed back onto the second or third pages or beyond.

These checks can help to identify any negative press associated with the entity, or its directors or senior managers. You can also use Google Streetview to check any premises referred to on the third party's stationery or website.

Credit checks
These checks are extremely useful in collating a wide range of information from different sources and consolidating the results, such as county court judgment data, trade payment performance data, statutory information from Companies House and any insolvency events. The three main credit reference agencies in the UK are Callcredit, Equifax and Experian.

Fraud databases
Fraud databases allow participants to share fraud information with one another. Some are industry specific (such as the Insurance Fraud Register) while others are cross-sector (such as Cifas and National Hunter).

Companies House
Companies House provides free information about companies such as directors and statutory filings. Pay particular attention to the date of incorporation, recent filing history and address changes.

Other sources
Information or documents provided by the third party should be verified to ensure they are correct and/or genuine. It is common for fraudsters to trip up on the detail. For example, they may use a VAT number that belongs to another company or a postcode that does not match the road name, or an address that does not exist. Bad spelling or grammar can also be a warning sign. It may also be worthwhile visiting the premises to avoid 'brass plate' entities that have no real presence.

You can use independent due diligence professionals where the risk is great, the volume or value of trade is significant, or the third party is based in an overseas location where information is not easy to obtain.

LEGAL CONSIDERATIONS

Organisations must comply with data protection and privacy legislation when handling information obtained through due diligence investigations, particularly if it has been acquired directly from the third party (such as a utility bill). Therefore it is important to have a data protection policy and to register with the Information Commissioner's Office (ICO) and follow its guidance.

There may also be contractual obligations that need to be adhered to if information has been provided under a contract, agreement or otherwise (eg, non-disclosure or confidentiality agreements).

UK anti-money laundering, and bribery and corruption legislation must also be complied with where applicable.

CASE STUDY: FRAUDULENT LOSSES CAUSED TO AN ESTABLISHED BUSINESS

A specialist stationery company provided goods to the value of £10,000 to a new business customer on credit, following negotiations with them. An invoice was sent but no payment was forthcoming despite the debt being chased. The company noticed that the customer's website was down, emails were bouncing and its telephone numbers were no longer working. Upon visiting the address, it became clear that it was a 'virtual office'.

If the company had performed a credit check it would have found that the customer had four county court judgments within the space of one week; had been labelled a 'scammer' on an internet forum; had registered its website domain to a 'Mr John Smith' two weeks before the order was placed; and had only been incorporated for six weeks.

CONDUCTING DUE DILIGENCE

Do:

- ✔ Take a risk-based approach to due diligence.
- ✔ Have robust and detailed policies and procedures in place.
- ✔ Draw on a range of different databases, datasets and information sources.
- ✔ Involve multiple individuals and departments in the process.
- ✔ Perform ongoing checks on a frequent basis throughout the relationship.
- ✔ Independently verify any requests to change supplier bank accounts or customer address details.
- ✔ Make third parties aware of your due diligence policies and seek compliance.
- ✔ Involve the use of professional due diligence firms to help where appropriate.
- ✔ Ensure that any individual acting on behalf of a third party is properly authorised to do so.
- ✔ Keep a record of all due diligence enquiries that are conducted.

Don't:

- ✘ Allow bad debts to build up. It may be a sign of fraud.
- ✘ Consider due diligence a tick-box exercise or optional 'bolt-on'.
- ✘ Ignore information that might be considered adverse.
- ✘ Treat due diligence as a 'one-off' event.
- ✘ Ignore changes in the behaviour or structure of a third party.
- ✘ Allow one person to investigate, administer and make the final decision on whether to transact business with a third party. These roles need to be segregated.

FURTHER INFORMATION

Available from the **resources** section of our website:

- Securing board-level support for anti-fraud measures
- An introduction to fraud investigations
- Supplier and outsourcing fraud.

Other resources

- **Companies House**
- **Information Commissioner's Office**

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FRAUD ADVISORY PANEL

Chartered Accountants' Hall
Moorgate Place
London EC2R 6EA UK

T +44 (0)20 7920 8721
E info@fraudadvisorypanel.org
www.fraudadvisorypanel.org

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