




# Fraud

## How to identify and tools to prevent/detect fraud in the credit union

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## Learning Objectives

- Identify the different types of internal fraud, common instances, and ways to avoid them.
- Understand fraud detection and prevention approaches.
- Understand what internal controls are and how they can be leveraged.
- Learn the roles and responsibilities of credit union team members and volunteers as it relates to internal controls.
- Learn approaches to investigate and address fraud in the credit union.

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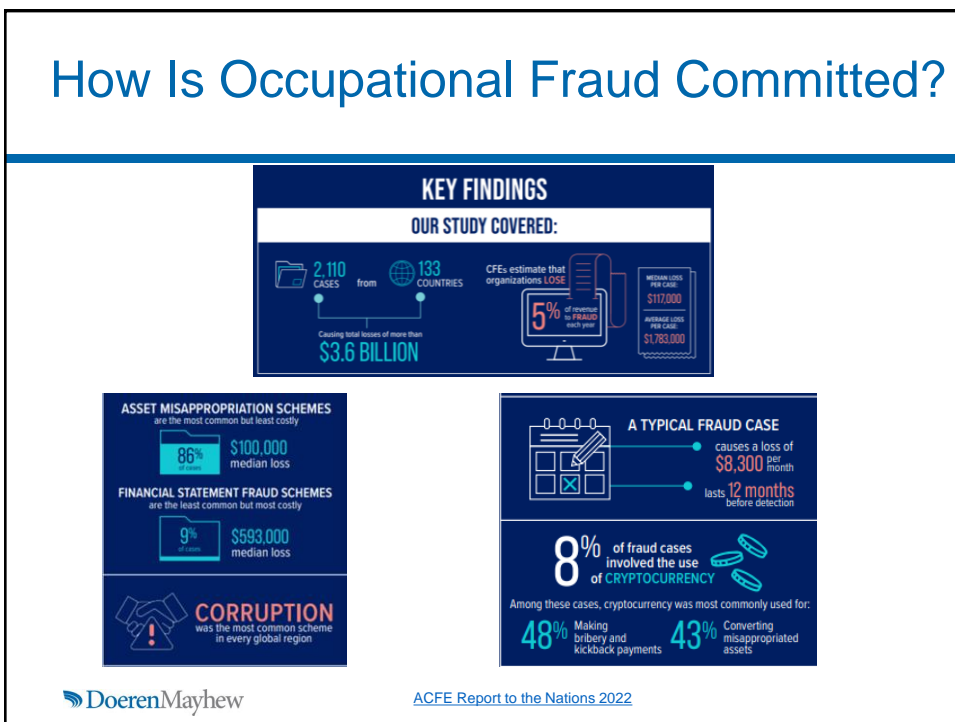
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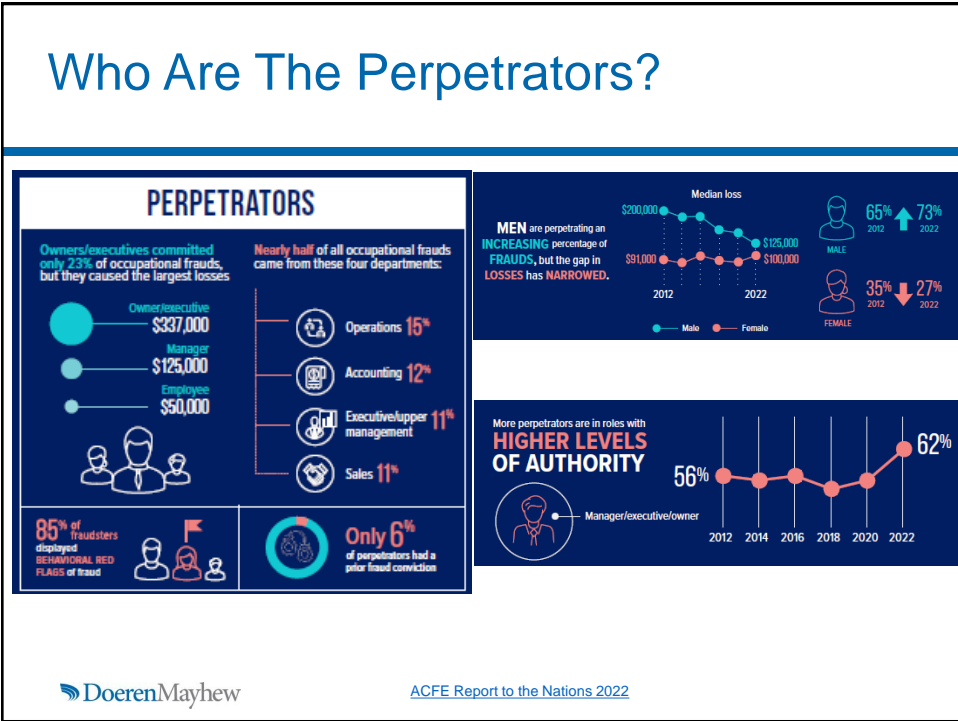
# Fraud Detection and Prevention

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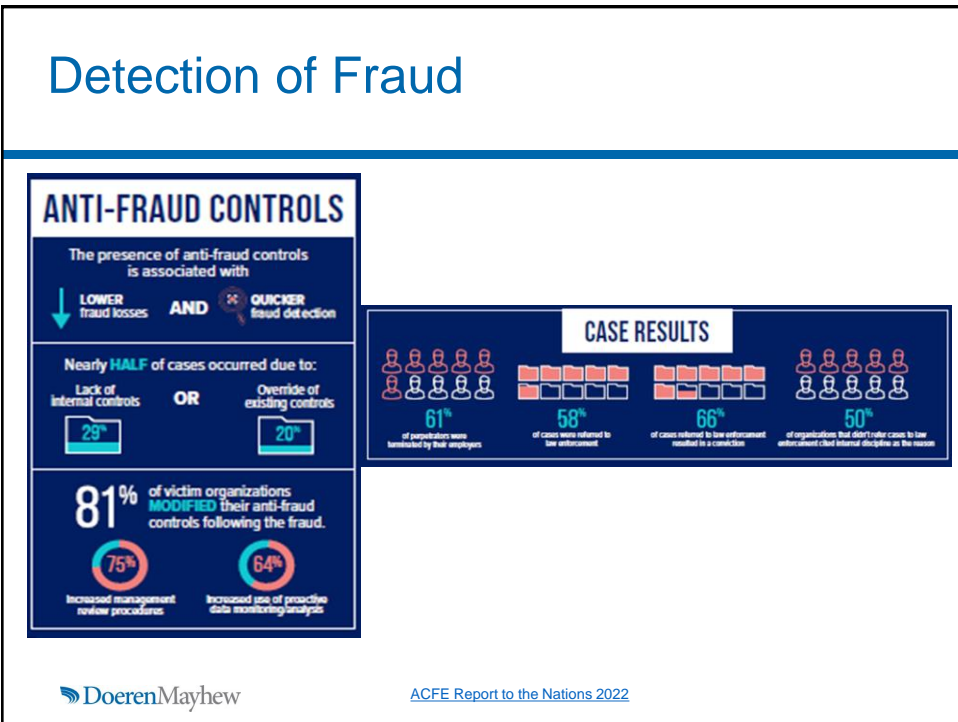
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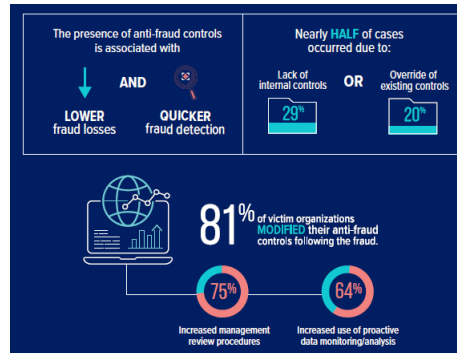


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## Internal Control Weaknesses Contributing to Fraud Risk



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## Fraud Red Flags: Conditions Conducive to Fraud

- Weakness in the system of internal control (segregation of duties and management overrides)
- Independent and domineering individuals (“nerves of steel”)
- Weakness in management abilities of senior officers
- Poor maintenance of records in file storage areas
- Lack of effective internal audit
- Limited or no review of employee accounts
- Lack of Board involvement or weak Audit Committee
- Poor staff morale or high turnover
- Incomplete or missing documentation

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## Fraud Red Flags: Conditions Conducive to Fraud

- Unusual relationship between borrower and respective loan officer
- High levels of personal indebtedness by employee
- Accounts which do not balance, such as “suspense”, “official checks”, “cash items” or “clearings”
- Accounts which are force balanced and which have high volume of activity
- Decisions made by one dominant individual
- Out-of-area lending
- Frequent deviation from policies, procedures or common practices - lots of exceptions

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## Fraud Red Flags: Conditions Conducive to Fraud

- No explicit / uniform personnel policies
- Inadequate attention to details
- Placing too much trust in key employees
- Pay levels not commensurate with the level of responsibility assigned
- Failure to discipline violators of company policy
- Not adequately checking background before employment

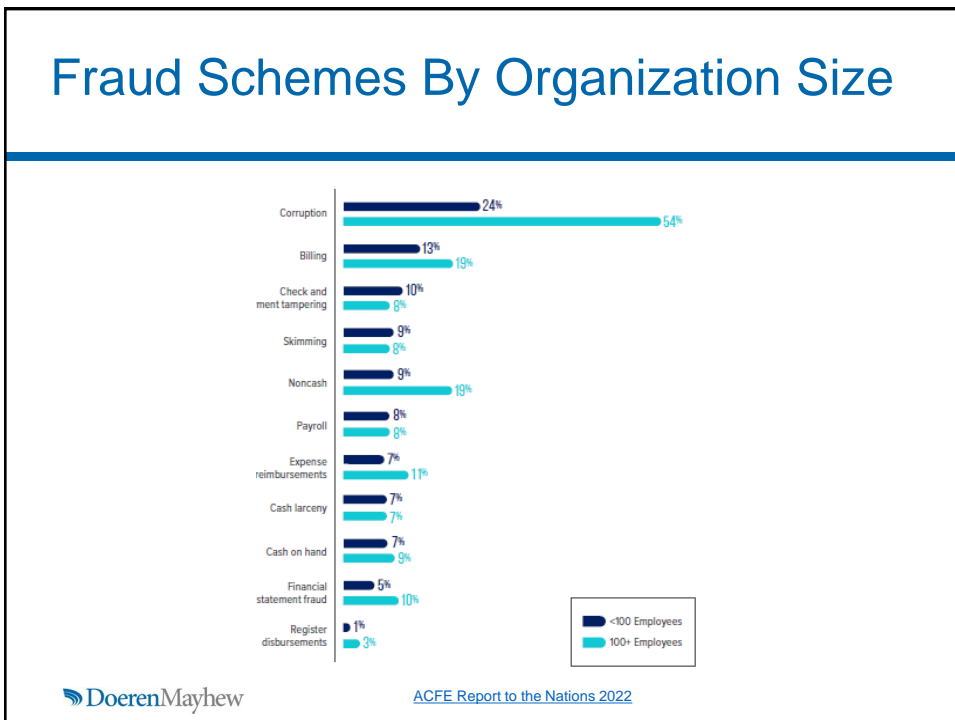
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# Financial Statement Fraud

Financial Statement Fraud

Net Worth/ Net Income Overstatements	Net Worth/ Net Income Understatements
Timing Differences	Timing Differences
Fictitious Revenues	Understated Revenues
Concealed Liabilities and Expenses	Overstated Liabilities and Expenses
Improper Asset Valuations	Improper Asset Valuations
Improper Disclosures	Improper Disclosures

The diagram consists of three overlapping circles. A large light blue circle on the left is labeled 'Asset misappropriation'. A smaller dark blue circle on the right is labeled 'Financial statement fraud'. A red circle at the bottom overlaps with both. The intersection of the light blue and dark blue circles is labeled 'Corruption'.

A simple bar chart with two vertical bars. The left bar is blue and the right bar is green. The green bar is significantly taller than the blue bar.

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# Fraud Concealment

## HOW DO PERPETRATORS CONCEAL THEIR FRAUDS?

Examining the methods fraudsters use to conceal their crimes can assist organizations in more effectively detecting and preventing similar schemes moving forward.

TOP 5 CONCEALMENT METHODS USED BY FRAUDSTERS

39%

Created fraudulent physical documents

32%

Altered physical documents

28%

Created fraudulent electronic documents or files

25%

Altered electronic documents or files

23%

Destroyed or withheld physical documents

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# How Is Fraud Detected?

FIG. 10 HOW IS OCCUPATIONAL FRAUD INITIALLY DETECTED?

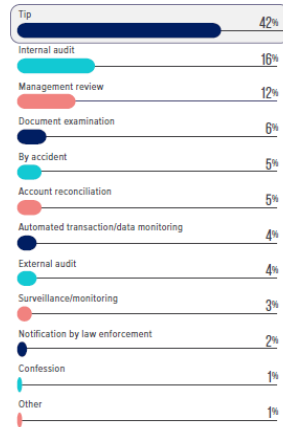
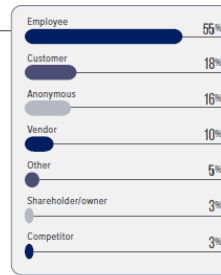
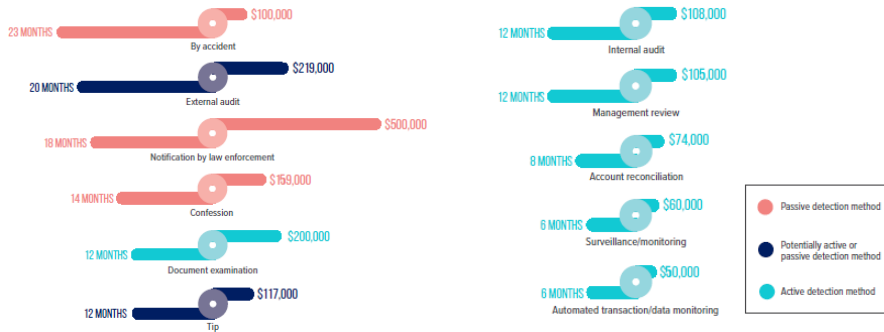


FIG. 11 WHO REPORTS OCCUPATIONAL FRAUD?



# How Is Fraud Detected?





## Anti-Fraud Controls by Size of Organization



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## Fraud Prevention

- ✓ Fraud training to all employees
- ✓ Fraud reporting mechanisms
- ✓ Increase employee detection perception such as surprise fraud audits, data analytics, management testing of controls, processes, accounts, transactions
- ✓ Management climate/tone of integrity and honesty
- ✓ Perform fraud risk assessments
- ✓ Implement strong basic controls such as separation of duties, mandatory vacation, authorization, job rotation and training, physical safeguards including limited access, periodic independent verification, management testing and review, automated vs. manual controls

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# Fraud Prevention

- ✓ Independent internal audit function
- ✓ Hiring policy includes past employment verification, criminal and civil background checks, credit checks, drug screening, education verification, reference checks
- ✓ Employee support programs
- ✓ Open door policy
- ✓ Anonymous surveys to assess employee morale



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# Common Occupational Fraud Schemes in Financial Services



INDUSTRY	Cases	Billing	Cash larceny	Cash on hand	Check and payment tampering	Corruption	Expense reimbursements	Financial statement fraud	Noncash	Payroll	Register disbursements	Skimming
Banking and financial services	351	10%	11%	14%	14%	46%	8%	11%	11%	4%	2%	10%



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## Internal Controls: What are They and What Can They Do

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## What is Internal Control?

- Before we discuss what you can do...what are internal controls?
  - A process, effected by an entity's Board, management and other personnel designed to provide reasonable assurance regarding the achievement of objectives in:
    - Effectiveness and efficiency of operations
    - Reliability of financial reporting
    - Compliance with applicable laws and regulations

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## Types of Controls

- Preventative: prevent undesirable "activities" from happening; deter the instance of errors or fraud
  - Segregation of duties
  - Authorization
  - Documentation
  - Security
- Detective: identify undesirable "occurrences" after the fact
  - Key control activity is reconciliation
  - Activity reports (master file changes)
  - Physical counts

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## What Internal Control Can Do

- Internal control can help a credit union:
  - Achieve performance and profitability targets
  - Prevent loss of resources
  - Ensure reliable financial reporting
  - Ensure compliance with laws and regulations

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## Roles and Responsibilities

### CEO

- Ultimately responsible and should assume “ownership” of the internal control system
- Sets the “tone at the top”

### Senior management

- Effectively a chief executive of his/her area of responsibility

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## Roles and Responsibilities

### Board of Directors/Supervisory or Audit Committee

- Provides governance, guidance and oversight
- Should be objective, capable and inquisitive

### Internal Auditors

- Play important role in evaluating effectiveness of control systems
- Often has significant monitoring role

### Other Management and Staff

- To some degree, the responsibility of everyone

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## Limitations of Internal Control

### Judgement

- Human error might occur in the process of making decisions
- Management biases and human judgment
- Based on information available at the time and usually within a limited time frame

### Breakdowns

- Potential for human error in execution
- Carelessness, distraction, being asked to focus on too many tasks
- Misunderstanding of instructions by a person

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## Limitations of Internal Control

- Collusion
  - Individuals acting together to perpetrate and conceal an action from detection
  - Between two or more employees, or between employee and outside party (customer/member, vendor or other related party)
- Management Override
  - Internal control only as effective as individuals responsible for its functioning
  - Overriding policies/procedures for illegitimate purposes with the intent of personal gain or enhanced presentation of performance

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## Types of Internal Fraud

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## Two Primary Types of Internal Fraud

- Financial Misstatement
  - Financial reporting fraud; not as prevalent...but could have disastrous consequences
  - Economic downturns result in “spikes”
  - Incentive Compensation/Bonuses
- Embezzlement
  - Employee fraud; some new “approaches” and some traditional “favorites”
  - Receiving more attention through “revamping” internal controls, internal audit, artificial intelligence techniques and “whistleblower” provisions

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## The Embezzlement Formula

Only **one** part is controllable

Motive

Opportunity

Rationalization

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## Common Control Weaknesses

- The List:
  - Financial Statement
  - Lending (there are many variations)
  - Branch operations (whether one branch or ten)
  - System access (who can do what?)
  - Member accounts (are they protected?)
  - Credit union fixed assets (easy to sell these days)
  - Member data (protection, COVID-19)

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## Financial Statement

- Misappropriation of funds
  - Loans
  - Investments
  - Other
- Manipulation of estimates/accounts
  - Incentives/Bonuses
- Preventing and detecting

## Lending Fraud: Types

- Fictitious loans
- Indirect lending arrangements
- Credit card loans
- Business lending (MBL) abuse
- Repo and foreclosure schemes



## Fictitious Loans

- Who creates these loans?
- What control weaknesses allow this?
- How are the loans created?
- How are the loans maintained?
- How are the loans paid off...and are they?
- Preventing and detecting



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## Indirect Lending Arrangements

- These result in “indirect” losses
- The risk is big...but where is it?
- The dealers...their role...and “kickbacks”
- What control weaknesses allow this?
- What do the fraudsters gain?
- Preventing and detecting



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## Lending Fraud: Credit Card Loans

- Often an “island” by themselves
- Tough area to control requiring special expertise
- Often serviced by third parties (separate system)
- What control weaknesses allow for abuse?
- What do the fraudsters gain?
- Preventing and detecting

## Business Lending (MBL) Abuse

- Fairly new area of concern
- Tough area to control requiring special expertise
- Participations - Location of business/property
- Data system...often separate from core system
- Incentives to grow the business?
- What control weaknesses allow for abuse?
- Is it “fraud” or “negligence” or both?
- Preventing and detecting

## Repo & Foreclosure Schemes

- These result in real losses
- Tough area to control requiring special expertise
- Repo - then fix (if needed) - then sell
- Are there checks and balances?
- Internal issue plus dealers
- What control weaknesses allow this?
- Preventing and detecting



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## Branch Fraud

- Why are **branches vulnerable**?
- Away from main office – proper controls?
- Are losses at branches “limited”?
- What is the worst that could happen?
- What about securing member information?
- Reputation risk more significant than lost cash
- Branch employee training...

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## Branch Fraud

- Many variations
  - Cash from vault teller box or ATM
  - Items under consignment
  - Privacy concerns...sloppy habits
  - Robbery...prepared?
  - Other issues...i.e., instant issue credit cards?

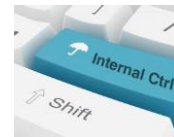
Group Participation >>>> Case Studies

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## System Access

- An open door to fraud “opportunity”
- Could result in cover up of cash or check diversion
- Restrict access to certain functions in data system
- Control over “terminated” employees
- Who can get away with this?
- What control weaknesses allow for abuse?
- Preventing and detecting



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## Member Accounts

- Certain member accounts are vulnerable to theft
- Elderly, dormant members not receiving statement
- Member education and information
- Member Data
- Reputation risk immense
- Review of **File Maintenance Reports** critical
- What control weaknesses allow for abuse?
- Preventing and detecting

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## Fixed Assets

- Computers, monitors, cables, supplies, etc.
- Theft or diversion often goes undetected
- Poor purchasing and inventory controls
- Who can get away with this?
- Need education for **all** employees in technical inventory awareness
- Preventing and detecting

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## Fraud Investigation Steps

1. Consultation – Internal/Legal/CPA – forensic accounting/Insurance
2. Investigation
  - Records are gathered and analyzed.
  - Potential fraud is explored, and the extent of financial losses are documented.
  - If the fraud is ongoing, specific controls and countermeasures may be recommended to protect from the threat of further damages

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## Fraud Investigation Steps

### 3. Identification

- Mapping out fraud
- Interviews/Cooperation of players
- Background of suspects

### 4. Asset Discovery

- Identification of suspect assets and use of fraudulent activity in the purchase

### 5. Termination/Legal Action/Prosecution



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Thank You!



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## Joseph A. Zito, CPA, MBA

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#### Areas of Expertise

- Audit and assurance
- Internal audit
- Regulatory compliance
- Commercial, real estate, and consumer lending reviews
- Mergers and acquisitions
- Enterprise risk management
- CECL implementation

For nearly 30 years, Joe has dedicated his time to helping companies in the financial services industry, including credit unions, community banks, mortgage companies, and credit card processors. Prior to joining the firm in 1995, he was gaining additional public accounting and financial institutions experience working for Ernst & Young and Comerica Bank.

Delivered through a comprehensive range of audit, regulatory compliance, lending and business advisory services, Joe provides valuable insight into all aspects of financial institution operations. From ensuring compliance with regulations, to evaluating internal controls, through implementing enterprise risk management, he leverages his in-depth diverse industry knowledge to assist clients.

A well-versed advisor, he also frequently guides clients through the complex merger and acquisition process and provides a path of vision through strategic planning procedures.

A nationally recognized speaker on a variety of audit, accounting, regulatory and business advisory issues related to financial institutions, Joe is often called on by national, regional, and local industry associations.

#### Education and Certifications

- Master of Business Administration - University of Detroit - Mercy
- Bachelor of Arts, Accounting – Wayne State University
- Certified Public Accountant (CPA)