Fraud Detection and Prevention

Presented by:
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Anthony Porter, CPA, Manager
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PRESENTATION OBJECTIVES

• At the end of the presentation, participants should be able to:
  o Understand the key global statistics on fraud and how they relate back to their credit union
  o Identify the key fraud risks and key fraud prevention/detection controls
  o Establish a culture of fraud awareness, prevention, and detection
WHY THE FOCUS ON FRAUD?

“At any given moment, there is a certain percentage of the population that’s up to no good.”

J. Edgar Hoover
WHY THE FOCUS ON FRAUD?

Report: 82% of executives admit to cheating on the golf course

Source: Fast Company
SIGN OF THE TIMES…

Loyal employees have bills to pay and families to feed. In a good economy, they would never think of committing fraud against their employers. But especially now, organizations must be vigilant during these turbulent times by ensuring proper fraud prevention procedures are in place.

ACFE President James D. Ratley, CFE
ECONOMIC RECESSION

- Employees pose the greatest fraud threat in the current economy
- Layoffs are affecting organizations’ internal controls
- Fraud levels are expected to remain elevated
FRAUD RISK

Opportunity

Pressure/Incentive

Rationalization
ASSOCIATION OF CERTIFIED FRAUD EXAMINERS

• The Association of Certified Fraud Examiners (ACFE) completes a report every two years summarizing the key characteristics of fraud.

• The most recent report is from 2012.

• The following are excerpts from that summary (total of 1,388 cases – worldwide)
MOST COMMON FRAUD – FREQUENCY

Source: ACFE 2012 Report to Nations
MOST COMMON FRAUD – MEDIAN LOSS

Source: ACFE 2012 Report to Nations
INITIAL DETECTION OF FRAUD

Initial Detection of Occupational Frauds

Tip: 43.3%
Management Review: 14.6%
Internal Audit: 14.4%
By Accident: 7.0%
Account Reconciliation: 4.8%
Document Examination: 4.1%
External Audit: 3.3%

Source: ACFE 2012 Report to Nations
SOURCE OF TIPS

Source: ACFE 2012 Report to Nations
IMPACT OF HOTLINES

Source: ACFE 2012 Report to Nations

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TYPE OF VICTIM - FREQUENCY

**Type of Victim Organization**

<table>
<thead>
<tr>
<th>Type of Victim Organization</th>
<th>2012</th>
<th>2010</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private Company</td>
<td>39.3%</td>
<td>42.1%</td>
<td>39.1%</td>
</tr>
<tr>
<td>Public Company</td>
<td>28.0%</td>
<td>32.1%</td>
<td>28.4%</td>
</tr>
<tr>
<td>Government</td>
<td>16.8%</td>
<td>16.3%</td>
<td>18.1%</td>
</tr>
<tr>
<td>Not-for-Profit</td>
<td>10.4%</td>
<td>9.6%</td>
<td>14.3%</td>
</tr>
<tr>
<td>Other*</td>
<td>5.5%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Percent of Cases

**Other** category was not included in the prior years' Reports.

Source: ACFE 2012 Report to Nations
SIZE OF VICTIM - FREQUENCY

Source: ACFE 2012 Report to Nations

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DISCUSSION

• Loan officer perpetrates a fraud by advancing funds on a revolving line
• Fraud goes undetected for an extended period of time
• Ultimately identified by a random account confirmation
• What could have been done to either prevent the fraud or to detect it sooner?
INDUSTRY OF VICTIM ORGANIZATIONS

Source: ACFE 2012 Report to Nations
## IMPACT OF FRAUD-PREVENTION CONTROLS

<table>
<thead>
<tr>
<th>Control</th>
<th>Percent of Cases Implemented</th>
<th>Control in Place</th>
<th>Control Not in Place</th>
<th>Percent Reduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management Review</td>
<td>60.5%</td>
<td>$100,000</td>
<td>$185,000</td>
<td>45.9%</td>
</tr>
<tr>
<td>Employee Support Programs</td>
<td>57.5%</td>
<td>$100,000</td>
<td>$180,000</td>
<td>44.4%</td>
</tr>
<tr>
<td>Hotline</td>
<td>54.0%</td>
<td>$100,000</td>
<td>$180,000</td>
<td>44.4%</td>
</tr>
<tr>
<td>Fraud Training for Managers/Executives</td>
<td>47.4%</td>
<td>$100,000</td>
<td>$158,000</td>
<td>36.7%</td>
</tr>
<tr>
<td>External Audit of ICOFR</td>
<td>67.5%</td>
<td>$120,000</td>
<td>$187,000</td>
<td>35.8%</td>
</tr>
<tr>
<td>Fraud Training for Employees</td>
<td>46.8%</td>
<td>$100,000</td>
<td>$155,000</td>
<td>35.5%</td>
</tr>
<tr>
<td>Anti-Fraud Policy</td>
<td>46.6%</td>
<td>$100,000</td>
<td>$150,000</td>
<td>33.3%</td>
</tr>
<tr>
<td>Formal Fraud Risk Assessments</td>
<td>35.5%</td>
<td>$100,000</td>
<td>$150,000</td>
<td>33.3%</td>
</tr>
<tr>
<td>Internal Audit/FE Department</td>
<td>68.4%</td>
<td>$120,000</td>
<td>$180,000</td>
<td>33.3%</td>
</tr>
<tr>
<td>Job Rotation/Mandatory Vacation</td>
<td>16.7%</td>
<td>$100,000</td>
<td>$150,000</td>
<td>33.3%</td>
</tr>
<tr>
<td>Surprise Audits</td>
<td>32.2%</td>
<td>$100,000</td>
<td>$150,000</td>
<td>33.3%</td>
</tr>
<tr>
<td>Rewards for Whistleblowers</td>
<td>9.4%</td>
<td>$100,000</td>
<td>$145,000</td>
<td>31.0%</td>
</tr>
<tr>
<td>Code of Conduct</td>
<td>78.0%</td>
<td>$120,000</td>
<td>$164,000</td>
<td>26.8%</td>
</tr>
<tr>
<td>Independent Audit Committee</td>
<td>59.8%</td>
<td>$125,000</td>
<td>$150,000</td>
<td>16.7%</td>
</tr>
<tr>
<td>Management Certification of F/S</td>
<td>68.5%</td>
<td>$138,000</td>
<td>$164,000</td>
<td>15.9%</td>
</tr>
<tr>
<td>External Audit of F/S</td>
<td>80.1%</td>
<td>$140,000</td>
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Source: ACFE 2012 Report to Nations

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<tr>
<td>Job Rotation/Mandatory Vacation</td>
<td>16.7%</td>
<td>9 months</td>
<td>24 months</td>
<td>62.5%</td>
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<tr>
<td>Rewards for Whistleblowers</td>
<td>9.4%</td>
<td>9 months</td>
<td>22 months</td>
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<td>24 months</td>
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<td>14 months</td>
<td>30 months</td>
<td>53.3%</td>
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<tr>
<td>Anti-Fraud Policy</td>
<td>46.6%</td>
<td>12 months</td>
<td>24 months</td>
<td>50.0%</td>
</tr>
<tr>
<td>External Audit of ICOFR</td>
<td>87.5%</td>
<td>12 months</td>
<td>24 months</td>
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<tr>
<td>External Audit of F/S</td>
<td>80.1%</td>
<td>17 months</td>
<td>24 months</td>
<td>29.2%</td>
</tr>
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Source: ACFE 2012 Report to Nations

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DISCUSSION

• Internal accountant responsible for approving invoices creates a fictitious company (a valid corporation is formed) and generates invoices to run through the credit union

• They were also responsible for new vendor approval and entry into the AP system

• They approve the invoices which are subsequently paid

• Only identified after they continued to increase the size of the invoice to level that was very noticeable

• How could this have been prevented or detected earlier?
PRIMARY INTERNAL CONTROL WEAKNESSES OF VICTIMS

Source: ACFE 2012 Report to Nations
DISCUSSION

• Individual responsible for reconciling suspense accounts steals from the credit union for an extended period

• They also have maintenance access to both deposit accounts and the general ledger

• Ultimately caught when they got too greedy and the impact was noticeable on the income statement

• How could it have been prevented or detected earlier?
WHO COMMITTED THE FRAUD

Source: ACFE 2012 Report to Nations
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Financial Services Group
WHO COMMITTED THE FRAUD

Tenure of Perpetrator — Median Loss

- Source: ACFE 2012 Report to Nations

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WHO COMMITTED THE FRAUD

**Education of Perpetrator — Median Loss**

- **Postgraduate Degree**
  - 2012: $300,000
  - 2010: $234,000
  - 2008: $210,000
- **College Degree**
  - 2012: $200,000
  - 2010: $196,000
  - 2008: $180,000
- **Some College**
  - 2012: $125,000
  - 2010: $136,000
  - 2008: $196,000
- **High School Graduate or Less**
  - 2012: $100,000
  - 2010: $100,000
  - 2008: $100,000
- **Other**
  - 2012: $38,000
  - 2010: $75,000
  - 2008: $75,000

**Median Loss**

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**Source:** ACFE 2012 Report to Nations

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SIGNIFICANT FRAUD RISK FACTORS

- Lack of detailed formal written policies and procedures
- Lack of segregation of duties
- Member complaints
- Unreconciled accounts and review of reconcilements
- Recurring audit findings
- Missing financial records
SIGNIFICANT FRAUD RISK FACTORS

- Untimely preparation of financial statements
- Lack of employee vacations
- Lack of significant control over transaction cycles
- Lack of management oversight
- Excessive employee addictions (gambling, drugs)
- Incorrect, incomplete, or erroneous financial reporting
- Lack of internal control reports from data processing system
SIGNIFICANT FRAUD RISK FACTORS

• Bonus or incentive plans
• Complex transactions
• Rapid growth
• Corporate credit cards
• Employee financial problems
• Inactive Supervisory Committee
• Lack of audit/verification
• Lack of employee training
• High employee turnover
ACFE – EXECUTIVE SUMMARY

- Asset misappropriation most frequent fraud, but financial fraud has the biggest dollar impact.
- Average life of fraud approximately 18 months.
- Tips continue to be the primary detection source.
- Smaller organizations most susceptible due to lack of controls.
- Anti-fraud controls helped to lower overall loss and duration.
- Frauds by executives cause the most damage.
- Organizations tend to over-rely on external audits as the fraud-prevention tool.
- Surprise audits were underutilized. Less than 30% of victims actually performed them. They are key “perception” tools to eliminate the “opportunity.”
INTERNAL CONTROL AND FRAUD PREVENTION TIPS

- Evaluate management’s assessment of fraud and mitigating controls.
- Evaluate the internal auditor’s testing of the effectiveness of each fraud control.
- Evaluate how management has “set the tone from the top” to promote ethical behavior.
- Communicate zero tolerance.
INTERNAL CONTROL AND FRAUD PREVENTION TIPS

• Ensure the internal audit function reports directly and candidly to the Supervisory Committee.
• Ensure that internal auditors continually conduct tests to detect fraud or control gaps.
• Follow up on prior audit findings from the internal auditor, external auditor, and regulators.
• Evaluate the nature and cause of findings.
• Ensure that annual fraud policy (or code of conduct) is signed by all employees.
BASIC INTERNAL CONTROL SAFEGUARDS

- Tone at the top
- Segregation of duties
- Whistleblower policy and hotline
- Rotation of personnel
- Mandatory vacations
- Reconciliation and review process
- Setting of accounting system privileges
- Access levels – review and adjust
THE REPUTATION RISK ASPECT OF INTERNAL FRAUD

Disgraced Tacoma banking leader admits to fraud - seattlepi.com
www.seattlepi.com/.../Disgraced-Tacoma-banking-leader-admits-to-fraud...-*
Sep 18, 2012 – The former head of a failed Tacoma bank’s home loans unit has pleaded guilty to charges related to a mortgage scam that saw mortgages ...

Tacoma bank-fraud exec gets 10 years | Business & Technology ... seattletimes.com/html/.../2020235498_portmannsentencedxml.html -*
Jan 28, 2013 – Former Pierce Commercial Bank executive Shawn Portmann received a 10-year prison sentence Monday for leading a mortgage-fraud scheme ...

Ex-loan officer sentenced for defrauding Tacoma Rescue Mission ... www.thenewstribune.com/2013/02/.../ex-loan-officer-sentenced-1.html -*
Feb 26, 2013 – The News Tribune / Tacoma, WA .... The bank acknowledged the fraud when the fraud was uncovered and fired Goodell, who was convicted of stealing ...

Former Tacoma bank exec gets 10 years in prison q13fox.com/.../former-tacoma-bank-exec-gets-10-years ...
Jan 28, 2013 – TACOMA -- A former senior vice president and chief operating officer of Pierce Commercial Bank was sentenced in federal court Monday for a multi-year scheme to defraud the bank of $1.9 million.

Hard to place a dollar value on the reputation risk related to internal fraud
THANK YOU

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