Risk Insights

Financial Industry: Stop Fraud in Its Tracks

Don't wait until you are working on fraud detection in your company

A LOAN OFFICER takes out a loan for a fictitious person, with loan disbursals then deposited in accounts accessible to that loan officer. A teller extracts shareholders' personal and account information from a database and then sells that data.

Financial institutions face many threats from fraud, and much damage accompanies the onset of a fraudulent scheme. Consider the financial costs alone:

- $200,000 median loss in fraud cases involving banks or other financial services organizations
- $154,000 median loss for organizations with 100 employees or less
- Five percent loss of all annual revenues for all international entities

Those findings are culled from the 2014 edition of the Association of Certified Fraud Examiners (ACFE) Report to the Nations on Occupational Fraud and Abuse.

Fraud is that destructive and that pervasive. The ACFE report divided schemes among the following three major categories of occupational fraud and abuse:

- Asset misappropriation
- Corruption
- Financial statement fraud

Asset misappropriation is the most common form of occupational fraud and includes incidents of fraudulent invoicing, payroll fraud, larceny and revenue skimming.

Corruption schemes encompass kickback payments, bribes or undisclosed conflicts of interest.

Financial statement fraud comprises various ways financial statements are falsified to provide an inaccurate view of company performance.

The ACFE report found that the average fraud scheme goes undetected for 18 months. When fraud is discovered, the full amount of the known tangible losses is seldom recovered. Recovering the intangible assets that fraud takes – assets such as goodwill, credibility and trust – is even more difficult.

Fraud Could Threaten the Existence of Some Financial Institutions

BILLION-DOLLAR FRAUD CASES capture considerable public attention, and unfortunately, financial institutions are among some of these. Small and large financial institutions rely upon trust in areas such as loan origination or branch operations. Often management does not establish and maintain the necessary preventative and detective controls. Further, individuals have too many responsibilities, with too little oversight. Background checks are not conducted to identify potential employees who have committed fraud and workplace theft elsewhere.

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Elements of Effective Fraud Prevention

SPECIFIC CIRCUMSTANCES VARY from one fraud case to another, but there are common elements found in all fraudulent schemes:

- Intent
- Motive
- Opportunity
- Repetitive acts
- Concealment

Individuals intending to commit fraud have differing motives. Some may want to live beyond their means, while others may be seeking to resolve financial difficulties. Some may feel resentful toward their employers and feel they are entitled to greater compensation.

Whatever the underlying motivations or rationalizations may be, perceived opportunity is a crucial factor in whether an individual acts upon an improper impulse or motive. A fundamental principle of effective fraud prevention is removing that perception of opportunity.

Investigation of tips regarding suspected improper activity is the most commonly cited means for detecting fraud. By regularly emphasizing fraud prevention, management creates an internal culture where individuals feel comfortable and compelled to report possible fraud. Such a culture dispels perceptions of opportunity.

Incorporating the concept of segregation of duties into individual job descriptions and responsibilities further combats that perception of opportunity. That concept is a foundational element of preventative fraud controls.

Segregation of duties separates incompatible responsibilities that present inherent conflicts of interest. That segregation establishes a natural system of checks and balances that not only deters fraud but also reduces errors. For various transaction cycles, segregating duties means that one person does not address all of the authorization, custody of assets, record keeping, control activity or reconciliation functions associated with any specific cycle.

Within a financial institution, for example, duties need to be segregated for loan origination, loan application and funding, payment/collection and delinquent loan recovery functions.

That segregation of duties needs to be reflected in computer access controls, too. An individual may plot to forward a shareholder's payments to a personal account at another financial institution. Not having access to all of the required applications or modules deters that person from executing that scheme.

In addition to maintaining segregation of duties within IT access privileges, managers need to recognize the advantages and fraud risks that accompany reliance upon IT in general. Technology delivers so many efficiencies. Technology, though, also makes it possible to initiate so many fraud schemes with keystrokes and mouse clicks. IT operability and security issues are now financial institution fraud prevention issues.

Fraud prevention measures incur initial costs and continual expense. The total expense, however, is typically less than the cost associated with just one incident of fraud detection. Fraud prevention saves financial institutions from having to make all of the costly and difficult calculations that accompany fraud detection.

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- Business continuity planning
- Business process improvement
- Contract monitoring and compliance
- Enterprise risk management
- Internal audit
- Internal control evaluation
- Integrated financial and IT audit
- Performance audit and measurement
- Regulatory compliance
- Risk assessment
- Sarbanes-Oxley compliance

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