ACUIA
Association of Credit Union Internal Auditors

29TH ANNUAL **CONFERENCE** & ONE DAY **SEMINAR**

What's New in Fraud Trends

Thursday, June 20, 2019
2:15pm – 3:45 PM

Presented by:
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DoerenMayhew
CPAs AND ADVISORS

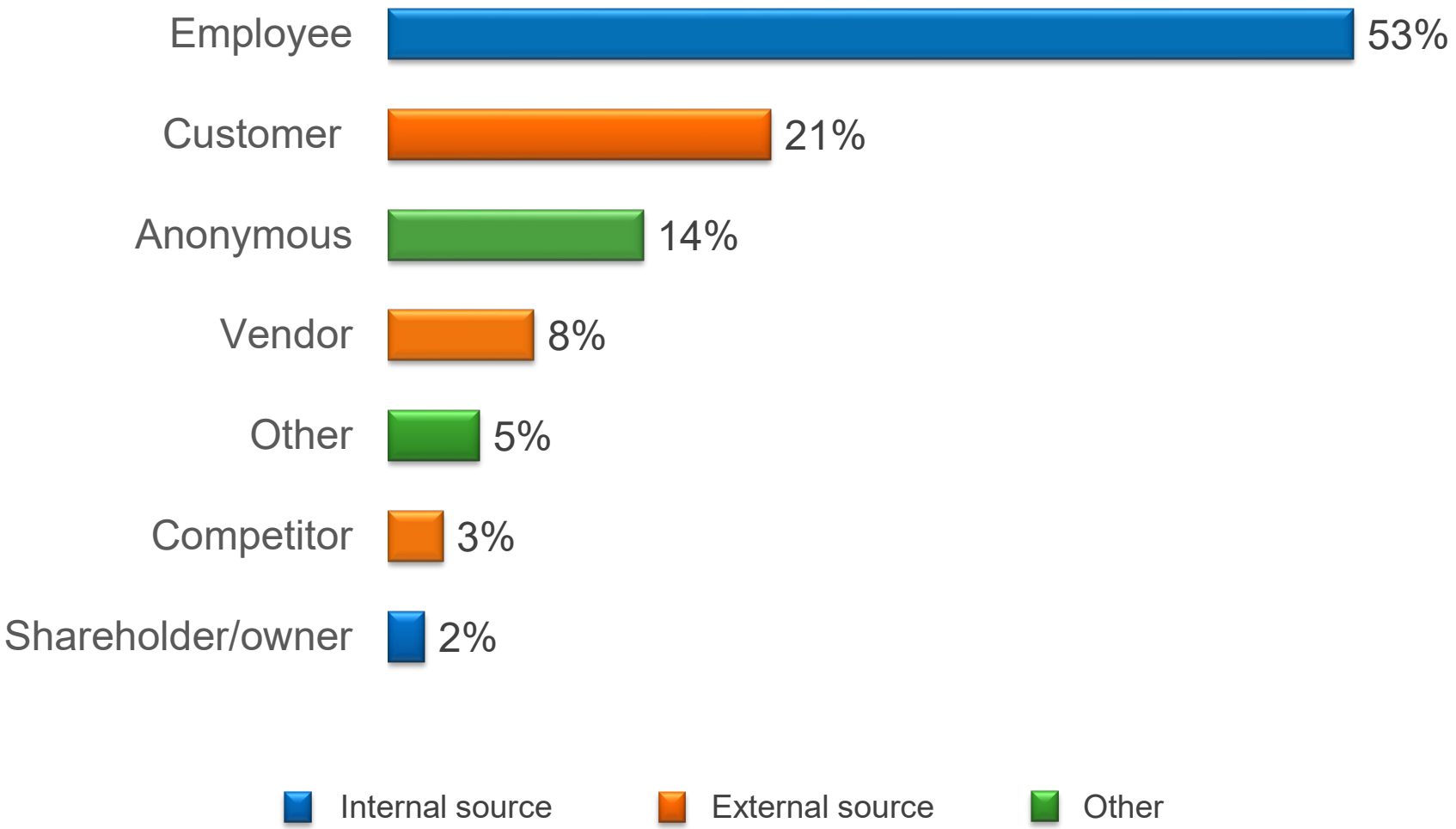
Overview

- Fraud data
- The environment of fraud
- Internal controls
- Roles and responsibilities
- Examples of control breakdowns
- Tools to detect now and in the near future
- Questions

How is Occupational Fraud Initially Detected?

Source: ACFE's 2018 Report to the Nations

Who Reports Occupational Fraud?



Source: ACFE's 2018 Report to the Nations

2018 ACFE Report to the Nations

- Cases of fraud reported increased 12%
  - 2,410 in 2016
  - 2,690 in 2018
- Losses increased from $6.3 billion to $7+ billion
- Median loss changed from $150,000 to $130,000
- Tips are still the most common way fraud is detected
  - 40% in 2018
  - 39% in 2016

Source: Association of Certified Fraud Examiners' 2018 Report to the Nations

2018 ACFE Report to the Nations

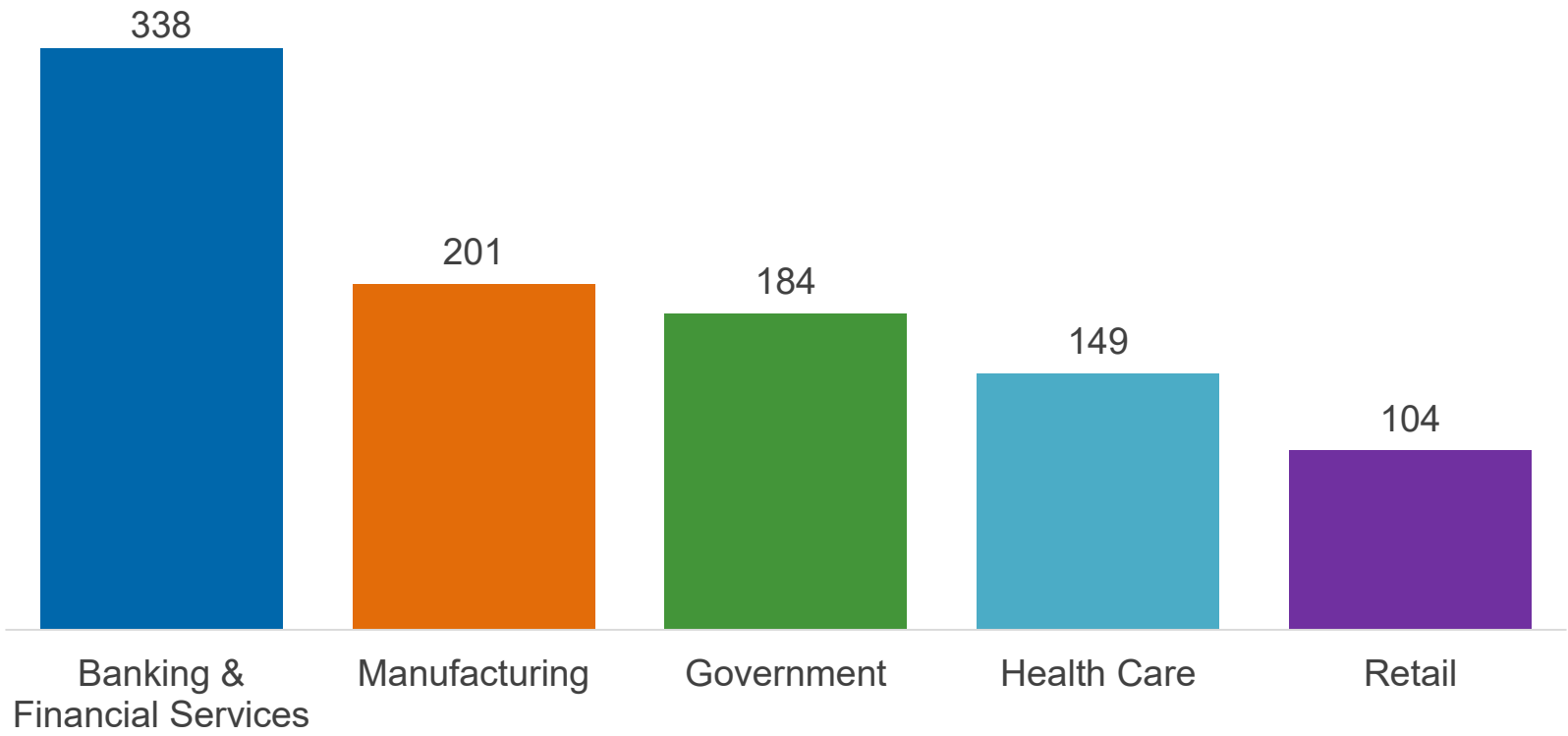
- 63% of victims have fraud hotlines
  - 46% of frauds were identified by tip when a hotline was present
- Private companies are more often victims of fraud
  - Private: 42% of cases
  - Public: 29%
  - Government: 16%
  - Other: 13%

Source: Association of Certified Fraud Examiners' 2018 Report to the Nations

Organization size in relation to employees does not fluctuate

Source: Association of Certified Fraud Examiners' 2018 Report to the Nations

Top 5 industries by cases submitted



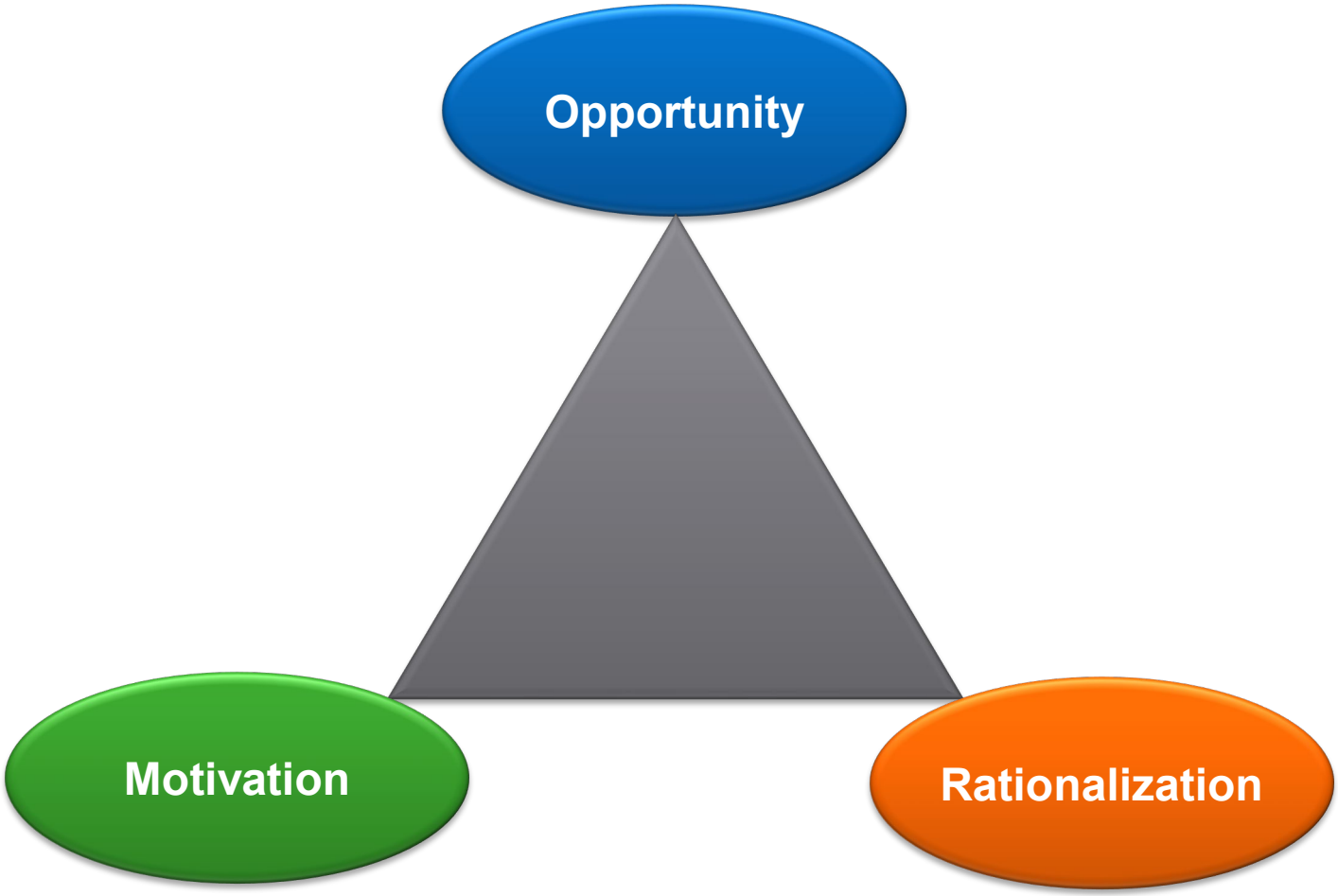
Source: Association of Certified Fraud Examiners' 2018 Report to the Nations

Fraud Environment
7 Signs of Ethical Collapse

1. Pressure to maintain the business numbers
2. Culture of fear and silence
3. A “bigger than life” supervisor and awe-struck direct reports who won’t go against their leader
4. A weak board of directors
5. A practice of conflicts of interest
6. A belief that the organization is above the law
7. **That goodness in some areas (such as corporate giving) atones for evil in others**

Excerpt: “The Seven Signs of Ethical Collapse” by Marianne Jennings

The Association of Certified Fraud Examiners' Fraud Triangle



Internal controls: What they are and what they can do

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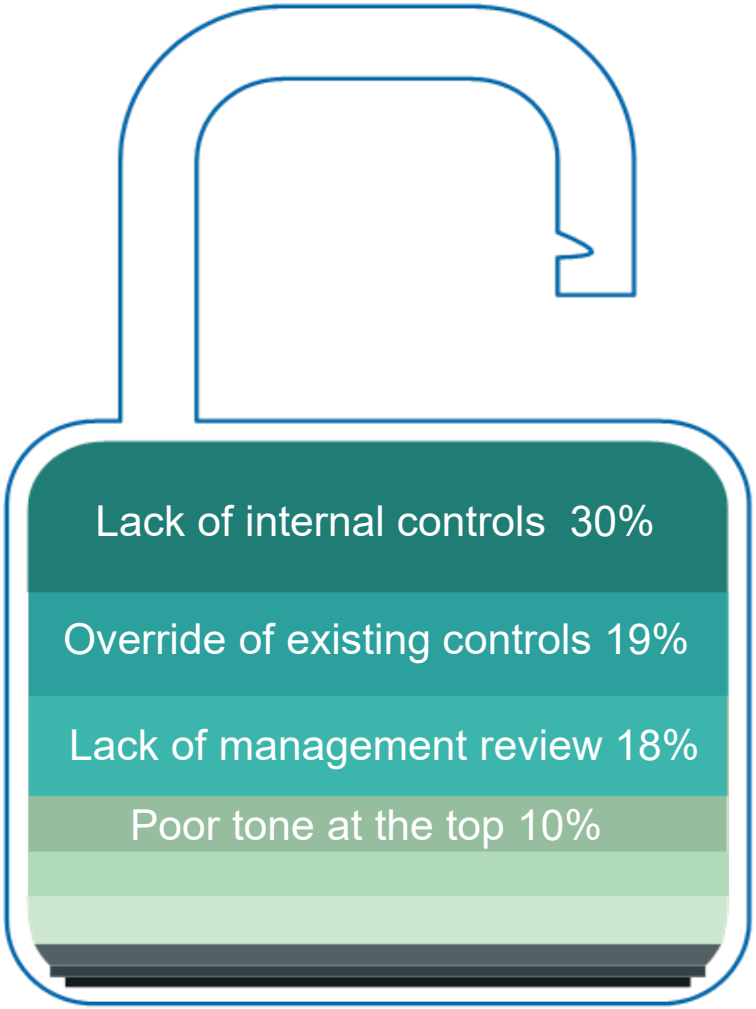
Internal Control Weaknesses That Contributed to Fraud

- Understanding the factors that can lead to fraud is the foundation of preventing future occurrences.
- The ACFE asked survey respondents what they perceived to be the primary internal control weakness that contributed to the fraud they reported.
- In 30% of cases, a simple lack of controls was the main factor that enabled the fraud to occur, while another 19% of cases occurred because the perpetrator was able to override the controls that had been put in place.

Source: ACFE's 2018 Report to the Nations

Primary Internal Control Weaknesses That Contribute to Occupational Fraud

Financial Institutions Group



Lack of competent personnel in oversight roles	8%
Other	6%
Lack of independent checks/audits	4%
Lack of employee fraud education	2%
Lack of clear lines of authority	2%
Lack of reporting mechanism	<1%

Source: ACFE's 2018 Report to the Nations

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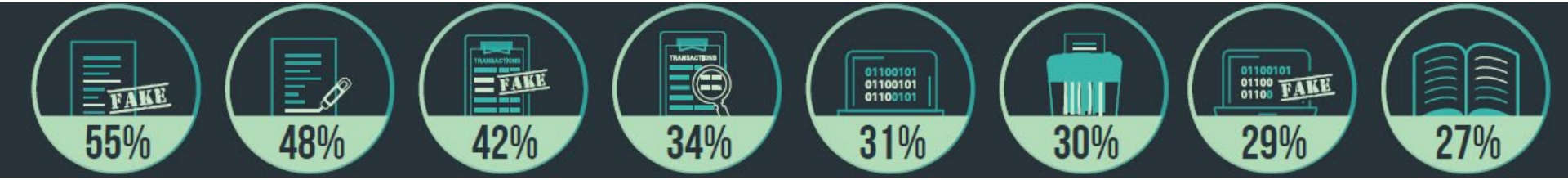
Concealing Fraud

"Fraud typically involves efforts to conceal the misdeeds. Understanding the methods fraudsters use to cover their crimes can help organizations better design prevention mechanisms and detect the warning signs of fraud."

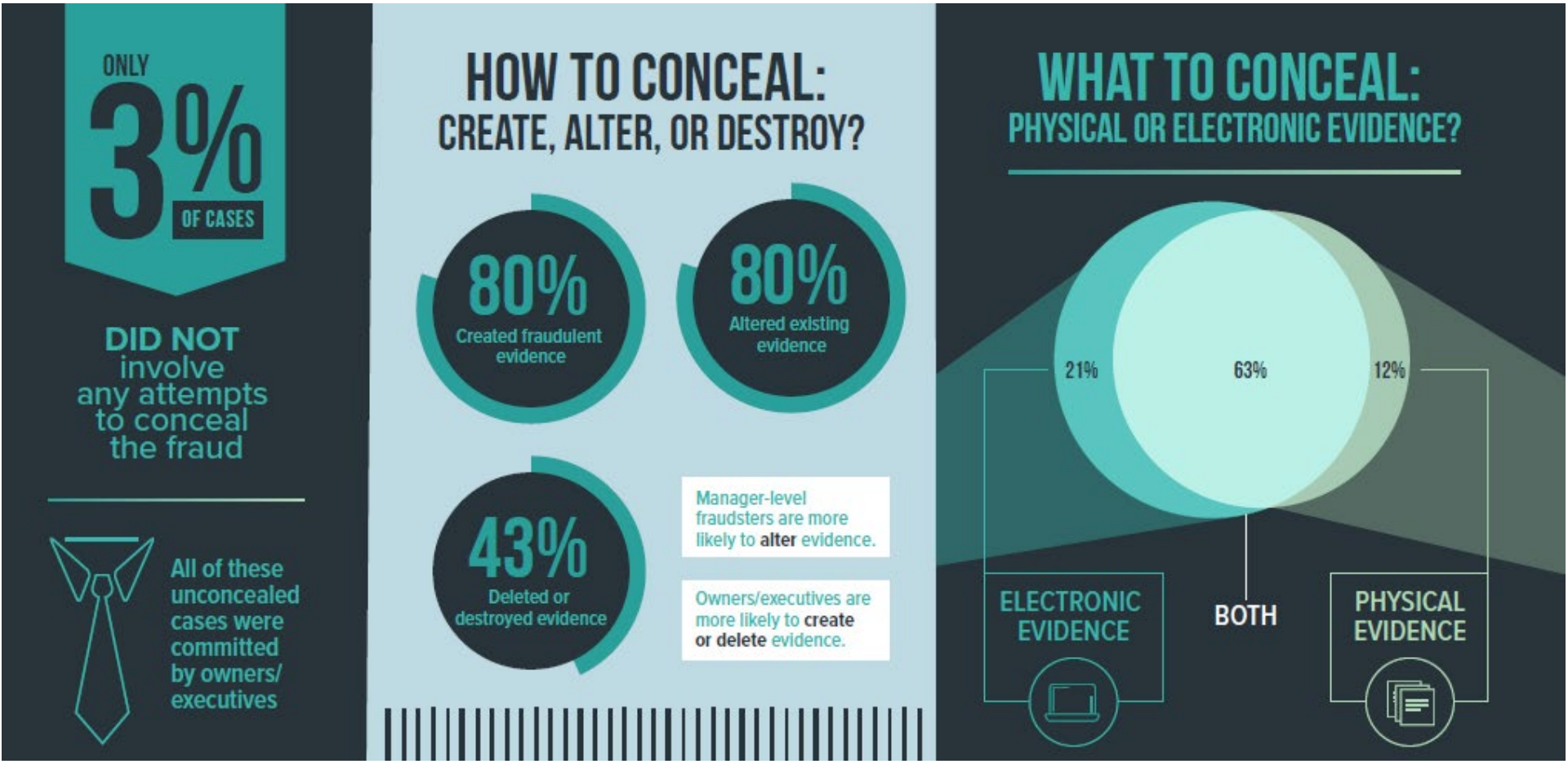
Top 8 Concealment Methods Used by Fraudsters



Created fraudulent physical documents	Altered physical documents	Created fraudulent transactions in accounting system	Altered transactions in accounting system	Altered electronic documents or files	Destroyed physical documents	Created fraudulent electronic documents or files	Created fraudulent journal entries

Source: ACFE's 2018 Report to the Nations

Concealing Fraud



Source: ACFE's 2018 Report to the Nations

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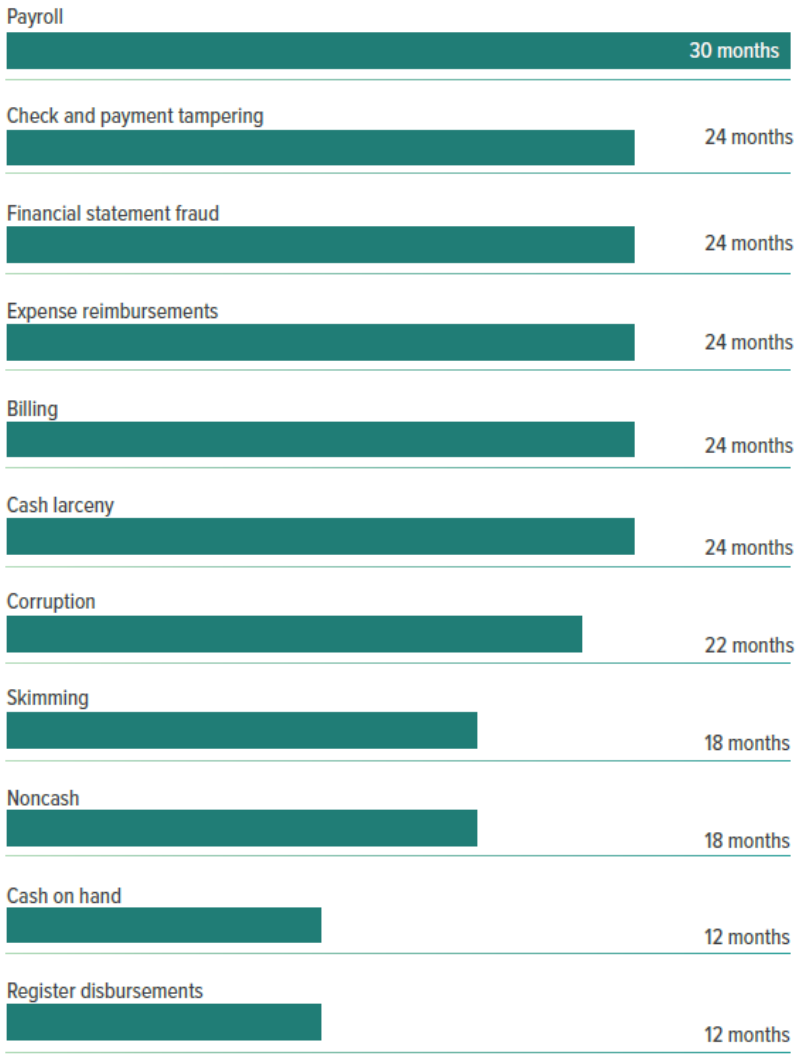
Duration of Fraud Schemes

How does the duration of a fraud relate to median loss?

Source: ACFE's 2018 Report to the Nations

Duration of Fraud Schemes

How long do different occupational fraud schemes last?



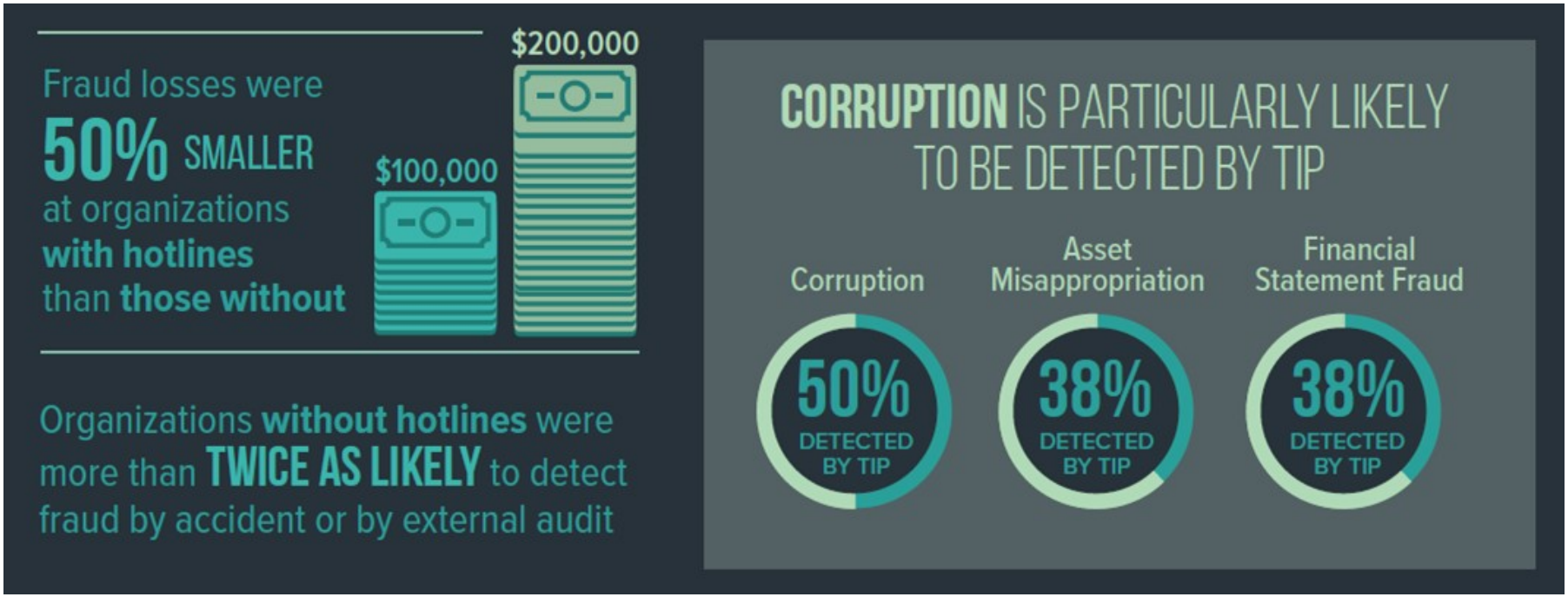
Source: ACFE's 2018 Report to the Nations

Hotlines and Reporting Mechanisms

The presence of a hotline or other reporting mechanism affects how organizations detect fraud and the outcome of the case.

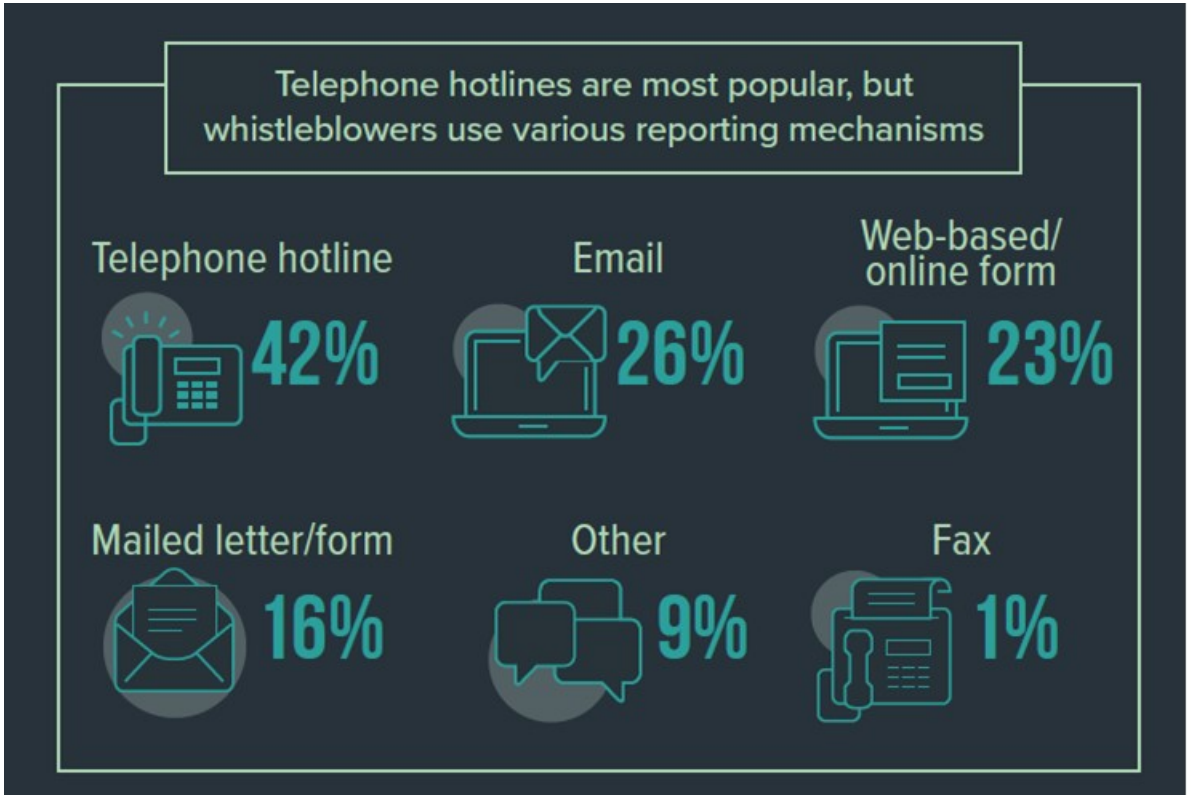
Source: ACFE's 2018 Report to the Nations

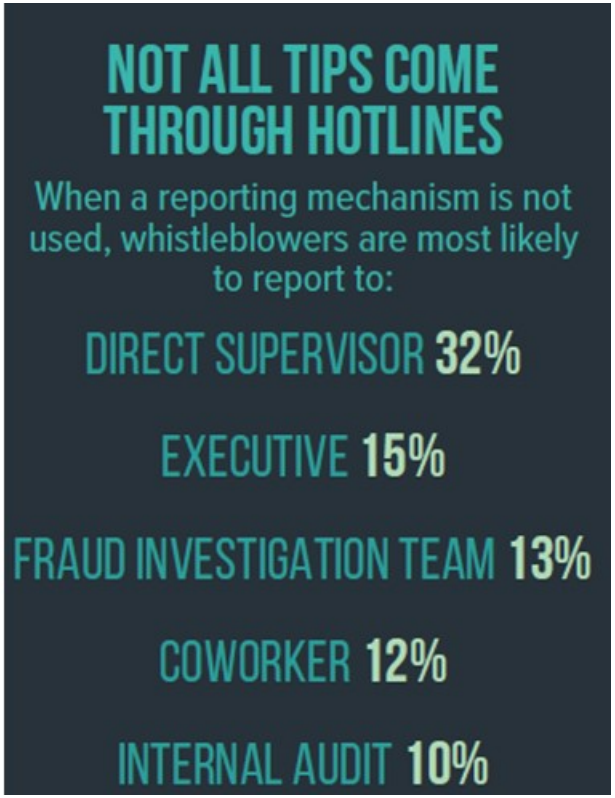
Hotlines and Reporting Mechanisms



Source: ACFE's 2018 Report to the Nations

Hotlines and Reporting Mechanisms





Source: ACFE's 2018 Report to the Nations

Internal Control Defined

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

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 (masterfile changes)
- Physical counts

Types of Controls

Corrective: make appropriate changes to errors identified by detective controls

- Procedures to remediate errors
- Training staff on existing procedures that are not functioning at desired success level
- Progressive discipline for repeated procedural errors

What Internal Controls Can Do

Internal controls help an entity:

- Achieve performance and profitability targets
- Prevent loss of resources
- Ensure reliable financial reporting
- Ensure compliance with laws and regulations

Roles & Responsibilities

Management

- 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

Roles & Responsibilities

Board of Directors/Supervisory or Audit Committee

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

Internal auditors

- **Independently** evaluate effectiveness of control systems
- Often has significant monitoring role
- Provide **unbiased** insight to leadership regarding effectiveness of existing controls

Other management and staff

- To some degree, the responsibility of everyone

Limitations of Internal Control

- Judgement
  - Human error in decision making process or execution
  - Management biases
  - Based on information available at the time and usually within a limited time frame
- Breakdowns
  - Lack of effective or sufficient controls
  - Carelessness, distraction, being asked to focus on too many tasks / Training
  - Volume / Complexity
  - Misunderstanding of instructions by staff (communication)

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 (member, vendor or other related party)
  - This breakdown can also occur without fraudulent intentions
    - Example: an employee signing as the dual control when they were not actually present so that everything “looks right”
    - Signing off as reviewed but not understanding what to review

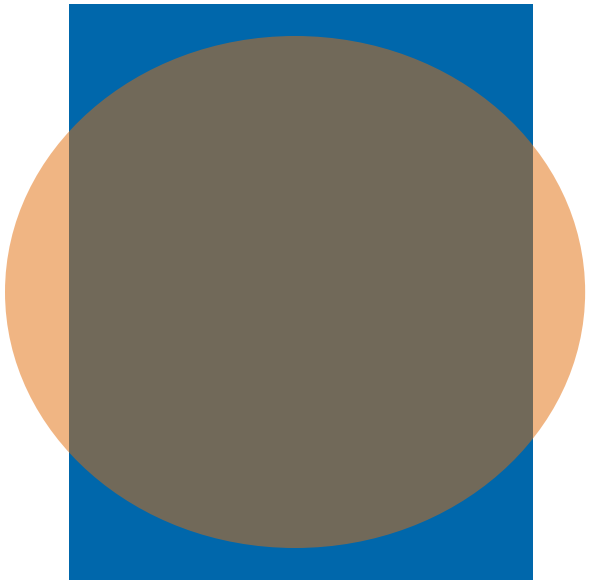
Limitations of Internal Control

- 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
  - Frequent overrides performed to speed up processes can also be an issue. If a control is regularly being bypassed, it cannot function as designed or intended

Limitations of Internal Control
Circle/Square Concept

Circle: Your internal control procedures

Square: What your employees really do



Breakdown Example
Wire Transfer Controls

- For wires taken by phone, a typical control is a secure callback to a number on file
  - If this callback cannot be completed, how often does management override the control?
  - Instances of large losses due to fraudulent wires sent after override of this control
- Validation of identity
  - Provide security data in the effort to help in member service

Being on the lookout…
It’s a puzzle

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Two Types of Internal Fraud

- Financial misstatement
  - Financial reporting fraud: not as prevalent…but could have disastrous consequences
  - Prior economic downturn resulted in an unusual “spike”
- Embezzlement
  - Employee fraud: some new “approaches” and some traditional “favorites”
  - Receiving more attention through “revamping” internal controls, internal audit and “whistleblower” provisions

The Embezzlement Formula

Only one part is truly controllable

Embezzlement Motivation

Only one part is truly controllable by Credit Union? What component is controllable from prior slide?

- Motive/Pressure
- **Gambling, Drugs**
- Lifestyle, Medical

The Embezzlement Formula

- What can we do in respect to pressure/motivation?
  - Monitor employee accounts for over-limit activity, negative balances, excessive fees, and check-kiting indicators
    - In most instances, the information is available to us to identify this piece of the formula prior to the occurrence of fraud
    - Evaluate fee reversals in GL income accounts
    - Control employee access to GL functions to record journal entries
  - Provide resources to employees identified as experiencing financial pressure
    - Budgeting help
    - Financial counseling
    - Environment of support (happy employees provide superior service)

Common Control Weaknesses

- Lending
  - There are many variations
- Branch operations
  - Whether one branch or 10
- Accounting
  - Reconciliations are the key
  - GL Access
  - Test reconciliations in review
- System access
  - Who can do what?
- Member accounts
  - Are they protected?
- Credit union assets
  - Easy to sell these days
- Off the wall
  - Getting creative

In the News

- Ex-Municipal Credit Union CEO hit with 5-year prison sentence
- Ex CEO caused 20 year $40 million dollar loss
- CEO of liquidated credit union admits embezzlement, inks plea deal
- Former credit union exec convicted in $1.5 million loan scheme
- California CU exec jailed for $1 million embezzlement
- CU CEO guilty of $2.1 million theft
- NCUA probes $6 million fraud in Ohio CU failure

In the News

- Lending chief convicted of $340,000 loan scam
- Branch manager jailed in $330,000 embezzlement
- Branch manager jailed 5 years for $275,000 embezzlement
- Teller jailed 3 years for $200,000 theft
- Accounting clerk stole $781,000 from Pinal County FCU
- Former VyStar CU mail clerk accused of $5.4 million fraud
- Manager stole to give herself pay raise

Example

CEO Jailed Six Years For $220,000 Embezzlement

HOUSTON, Texas -- The former CEO of Deer Park FCU was sentenced to six years in state jail for stealing almost $220,000 from the credit union.

Dawne Wilson, 43, was manager and sole employee of the one-time $9 million credit union located inside City Hall from 2004 to 2011 and handled the daily operations without any direct supervision. She began stealing from the credit union in January 2007 and the theft went undetected until 2011 when an outside audit uncovered evidence of fraudulent loan activity.

Wilson stole the money using a variety of methods including funding fake loans using member's names or fictitious names and depositing the proceeds to her personal account.

What Went Wrong?

- Credit union had $9 million in total assets with 1 employee
- National average in small credit unions ($10M - $50M) should have 1 employee for every $3M in assets
- Manager allowed to approve and disburse loans to members without Supervisory Committee oversight
- Manager allowed to open new member accounts without supervision

How To Prevent It From Happening To You

- Documentation, including driver's license and credit reports, should be reviewed by Supervisory Committee at least quarterly for all new accounts
- Review of new loans originated by the credit union including validating the disbursement of loan proceeds through the whole process (i.e., check disbursement or deposit to member account)
- Implementation of these 2 control points would have identified the fraud earlier than the 4 years elapsed

Example

CEO of liquidated credit union admitted embezzlement, inked plea deal (2019)

A former California CU CEO admitted to embezzling millions of dollars and signed a plea deal.

According to court documents, Edward Martin Rostohar, who led CBS Employees FCU at the time of its liquidation, pleaded guilty to one count of bank fraud with the U.S. Attorney's Office in Los Angeles.

In the plea agreement, Rostohar admitted to carrying out a long-term scheme (almost 2 decades) to defraud the credit union, resulting in losses of more than $40 million.

Rostohar also forfeited various assets, including accounts at Wells Fargo and BoA, as well as property he owned in Los Angeles, Reno, and Cabo San Lucas.

What Went Wrong?

- Control concentrated in one employee
- Other employees did not report unusual transactions to the Board

Example

NCUA Probes $6 Million Fraud In Ohio CU Failure (2012)

NCUA investigated what it suspected was an elaborate fraud that led to the December 2012 failure of G.I.C. FCU, a $16 million Euclid, Ohio, credit union and is projected to cost the NCUSIF more than $6 million in losses.

Preliminary investigations conducted by NCUA and criminal authorities found the credit union was insolvent due to an embezzlement perpetrated by the manager, which involved an elaborate scheme to falsify CDs, investment statements, and bank statements to conceal an $8.1 million shortage in the credit union's asset accounts.

NCUA liquidated the 76-year-old credit union and assigned its remnants, which included 3,400 member accounts, to Steel Valley FCU, of Cleveland, in a purchase and assumption agreement.

Source: CUJournal.com

What Went Wrong?

- Investment authorization, execution, recording and reconciliation was limited to one individual
- Access and control over bank accounts was provided to the CEO

How To Prevent It From Happening To You

- Segregation of duties
  - One individual should not have access to authorize, execute, record and reconcile investment accounts and bank accounts
  - Secondary employee should be responsible for execution of investment purchases
- Supervisory committee review of investment transactions performed on a periodic basis, annually

Example

Ex-Municipal Credit Union CEO hit with 5-year prison sentence (2018)

Kam Wong, 63, former CEO of Municipal Credit Union of New York, was sentenced to more than 5 years in prison for embezzlement and fraud.

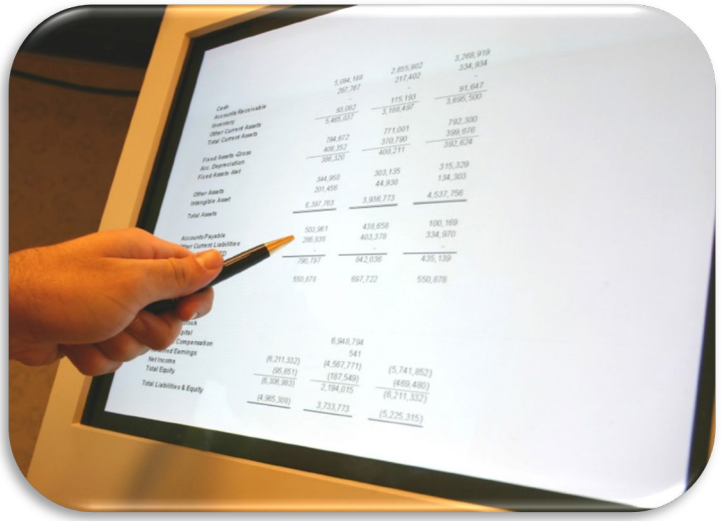
- During Wong's tenure, he engaged in a "long-running multi-faceted scheme to obtain money" and "took steps to seek to conceal" his actions. Among other things, he defrauded MCU by presenting phony invoices for dental work he never had done, receiving reimbursement for hundreds of thousands of dollars.
- Wong used his ill-gotten cash to purchase luxury items, including a Mercedes-Benz, among others. He also used cash to fund the educational, housing, and living expenses for two of his relatives.
- Wong was arrested in May 2018 and subsequently terminated by the credit union in June 2018.
- Wong's gambling and drug addictions were the primary causes for his actions, sentiments the judge in the case agreed with. His attorney his client hopes to "alert people to the dangers of such actions upon his release from prison."

What Went Wrong?

- High level executive with access to post and impact member accounts

How To Prevent It From Happening To You

- Review of monthly expense reports for substantiated documentation



Example

Up to 20 Years For Embezzling Manager of Failed Michigan Credit Union (2013)

Sharon Broadway was sentenced to 10 - 240 months for embezzling $2.1 million since 1985 from the Temperance, Mich. credit union, which collapsed in the wake of the crime. She was also sentenced to concurrently serve 45 months - 240 months for racketeering and ordered to pay $2.5 million in restitution to NCUA.

As manager, secretary, board member, and sole employee of the $300,000 UCCU, Broadway was able to conceal her crimes for years using a complex money laundering scheme involving forged checks and multiple aliases.

Broadway used the embezzled funds for her personal use, authorities said.

After she was taken into custody immediately after her sentencing, her lawyer, Lorin Zaner, said it's unlikely his client will be able to make full restitution. He said Broadway had found another job but not yet started the position, reported the *ToledoBlade.com*.

Broadway's fraud was uncovered after a routine examination by the Michigan Office of Financial and Insurance Regulation revealed a substantial amount of CDs went un-recorded in the credit union's financial records.

What Went Wrong?

- One employee branch location
- No oversight from the Board of Directors
- Long tenured employee; trusted by the Board

How To Prevent It From Happening To You

- Regular new member account audits by internal audit and or other external independent source.

Accounting/Financial Reporting

- Reconciliation issues
  - Conversion
  - Training / turnover
  - Theft
- Aggressive / unrealistic goals
  - Incentives
  - Performance

Types of Lending Fraud

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

Fictitious Loans

- How are the loans created?
- How are the loans maintained?
- How are the loans paid off…and are they?
- What control weaknesses allow this?

Fictitious Loans
How They Happen

- A long-tenured employee experiencing financial pressure knows the system, changes the address on a seldom used account and funds a fictitious loan
  - This scheme can continue to grow as the employee uses proceeds from additional fictitious loans to pay off previous loans
- A member, in collusion with an employee, submits falsified information to obtain approval
- An individual impersonates another member to obtain funds under someone else's name

Fictitious Loans
Preventing and Detecting

- Do we have effective controls in place to **prevent**?
  - Approval requirements
  - Documentation requirements
  - Dual control over approval and disbursement/proper segregation
  - Segregation from collection efforts/file maintenance
- Do we have effective controls to **detect** them should they occur?
  - Monitoring first payment defaults
  - Regular review of approved loan sample by QC and/or IA

Indirect Lending Arrangements

- These result in “indirect” losses
- The risk is big…but where is it?
- Two main types of indirect loan programs
- The dealers…their role…and “kickbacks”
- What control weaknesses allow this?

Indirect Lending Arrangements How It Can Happen

- High-pressure, fast-moving environment; dealers want loans funded quickly and financial institutions compete for business
- Employees with approval authority enter into scheme with dealerships submitting applications and receive kickbacks for approval
- Dealers take advantage of leverage in having multiple funding sources and credit union's desire for loan growth to push loans with high negative equity or excessive back-ends
- Dealerships learn where corners can be cut in documentation requirements

Indirect Lending Arrangements Preventing and Detecting

- Preventive controls
  - Approval process for new dealer arrangements
  - Dealer relationship maintenance – site visits
  - Proper underwriting and approval
- Detective controls
  - Dealer monitoring – activity levels and loan performance
  - Review of “add-ons” at dealership level
  - Regular review of approved loan samples by QC and/or IA

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?

Credit Card Loans
How It Can Happen

- As with all loans, an approval can be given where the applicant or employee grossly overstates income
- Employees colluding with applicants for kickbacks or a share of what will eventually be reported as fraudulent transactions
- Employees taking advantage of their access to obtain credit card numbers

Credit Card Loans
Preventing and Detecting

- Preventive controls
  - Approval process for new credit cards
  - Setup and ordering of new cards
- Detective controls
  - Monitoring of fraud activity
  - Can increased levels of fraud be traced back to a single approver or processor?
  - Regular review of new credit card sample by QC and/or IA

Business Lending (MBL) Abuse

- Fairly new area of concern
- Tough area to control requiring special expertise
- 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 and 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

Insider Deals

- Traditional area of concern
- Special treatment beyond what members receive
- Not always just loans
- Abuse of trust – they think they're special
- Vendors and kickback schemes
- What control weaknesses allow this?

Insider Deals
Preventing and Detecting

- Preventive controls
  - Does vendor selection process for significant purchases require proper vetting and multiple levels of approval?
  - Staff training
  - Annual independence acknowledgements by senior leadership and Board
- Detective controls
  - Review of approved contracts and loans
  - Accounts payable audit

Member Accounts

- Certain member accounts are vulnerable to theft
  - Elderly, dormant, members not receiving statements
- Member education and information
- Reputation risk immense
- What control weaknesses allow for abuse?

Member Accounts
Preventing and Detecting

- Preventive controls
  - Dual control over new account process
  - Identification requirements
  - Proper override / dual control requirements for dormant account transactions
- Detective controls
  - Monitoring file maintenance activity is critical
  - Regular review of dormant account activity
  - Regular review of new accounts by QC and / or IA

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
- Who has “Administrator” rights?
- Access levels to systems “as needed”
- Control over “terminated” employees

System Access
Preventing and Detecting

- Preventive controls
  - Ensuring user roles are administered by the appropriate employee(s) and require proper approval
  - Policy / procedures limit access rights to minimum required
  - Termination process includes removal of all system access
  - Rights for employees transitioning roles are properly changed; new rights are not simply added to existing rights
- Detective controls
  - Regular review of user roles in all systems

Credit Union 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

Credit Union Assets Preventing and Detecting

- Preventive controls
  - Inventory of assets
  - Process for disposal of unused / outdated assets
  - Segregation of duties in purchasing approval, payment and receipt
  - Staff training
- Detective controls
  - Periodic verification of recorded inventory
  - Review sample of executed invoices
  - Purchasing / Accounts payable audit

Corrective Controls

- For the areas discussed, are proper channels in place for management to take prompt and effective corrective action if an error is detected?
  - Effective communication
  - Escalation procedures
  - Staff training and awareness
  - Disciplinary procedures documented in policy and implemented by management
  - Responding to and tracking of audit findings

Off the Wall - Other

- Fake employees lead to fake salary
- Is overtime and salary rate accurate?
- Expense reimbursement for “non-expenses”
- Insurance proceeds for fake and real claims
- Preventing and detecting

Tools to Assist in Fraud Identification

- Continuous audit concepts
  - Use by management, internal audit, external audit, examiners
- Artificial intelligence
  - Increased scope capability; 100% transaction review
  - Pattern and micro-pattern identification
  - Financial transactions are assessed with multiple coded risk profile characteristics on each general ledger transaction
  - Enhanced audit capability to isolate anomalies with massive speed and efficiency
- Block chain

Thank you

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