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Fraud Risk Assessment

ACUARP Region 3
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Today's Presenters

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Agenda



Define what is fraud



Fraud Risk Assessment Process



Discuss fraud red flags and what to look for



Review key internal controls at credit unions





What is Fraud



What is Fraud?

Definition: an intentional act that results in a material misstatement in financial statements that are the subject of an audit.

- Two types of misstatements are relevant to the consideration of fraud:
 - Misstatements arising from fraudulent financial reporting
 - Intentional misstatements or omissions of amounts or disclosures designed to deceive
 - Example: misstating call report to reach regulatory reporting requirement such as maintaining a well capitalized net worth position
 - Misstatements arising from misappropriation of assets (theft or defalcation)
 - Examples include fictitious loans and theft of cash



Characteristics of Fraud

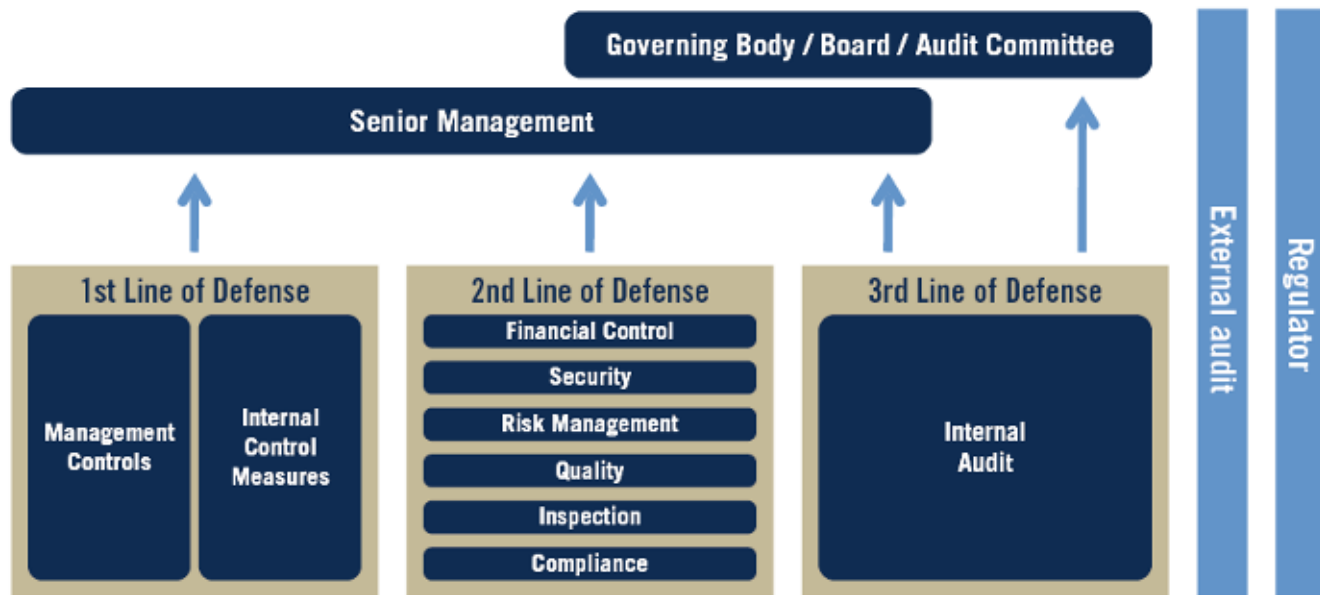
Three conditions generally are present when fraud occurs:

- **Incentive/pressure** -- reason to commit fraud
- **Opportunity** -- absence of controls, ineffective controls, ability of management to override controls
- **Rationalize/attitude** -- individual possesses a character or set of ethical values that allows them to commit fraud



Fraud Risk Management

The Three Lines of Defense Model



Adapted from ECIIA/FERMA *Guidance on the 8th EU Company Law Directive, article 41*

Source: IIA Position Paper: *The Three Lines of Defense in Effective Risk Management and Control*

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CFO vs. External Auditor vs. Forensic Investigator

Understand the varying roles of the CFO, external auditor, and forensic investigator

Why is it important for an institution to understand these varying roles?



How Difficult is it to Identify Fraud?



Many institutions are targets of insider and outsider fraud due to the easy access to money



As fraud becomes a more prevalent issue, it is important to understand when an environment is ripe of fraud and the ways that fraud is identified



Who Can Commit Fraud?

- **Anybody is capable of committing fraud**
- *Report to the Nations – Some statistics on Perpetrators*
- Perpetrator's level of authority has been strongly correlated with the size of the fraud
 - Only 23% Of frauds in the current study were committed by owners/executives, but the median loss in these cases was \$337,000.
- Correlation between the fraudster's level of authority and the duration of the occupational fraud scheme
 - The typical fraud committed by an employee lasted eight months before it was detected, whereas the typical fraud committed by an owner/executive lasted 18 months. Frauds committed by managers had a median duration of 16 months.





Fraud Risk Assessment Process



Components of a Fraud Risk Assessment



Identifying Fraud Risks

Conduct interviews
with various levels



Focus on red flags and
indicators of fraud



Involve various
departments and
stakeholders



Assessing Likelihood and Impact



Criteria for evaluating the likelihood of fraud risks

Historical data, current environment



Assessing the potential impact on the organization

Financial loss, reputational damage



Risk ranking and prioritization

Evaluating Existing Controls

- Importance of assessing internal controls in place
 - Brainstorm controls across the business segments
- Identifying gaps or weaknesses in current controls
- Identify examples of robust fraud prevention controls, such as segregation of duties, regular audits, and strong access controls



Developing a Fraud Risk Response Plan



Creating strategies to mitigate identified risks



Implementing new controls or strengthening existing ones



Ongoing monitoring and reviewing of the risk assessment



Role of Internal Auditors in Fraud Risk Assessment



Key responsibilities of internal auditors in the process



Auditors as the first line of defense



Ensuring ongoing vigilance and adherence to best practices





Fraud Red Flags



What to Look For

Red Flags

- Missing or edited journal entries
- Changes in work habits or behaviors
- Refusal to take vacation
- Employee makes unexpected, large purchases
- Missing inventory, equipment, or money
- Employee claims larger than normal travel expenses



NCUA Examiner Guide Red Flags

- Operational Red Flags
 - Overly dominant manager
 - Management or key employees involved in gambling
 - Management or key employees not taking regular vacations or always working late hours
 - Nepotism on part of directors or management
 - Other forms of insider abuse or preferential treatment
 - Limited personnel not conducive to segregation of duties
 - Lack of segregation of duties, when staffing allows



NCUA Examiner Guide Red Flags

- Operational Red Flags (continued)
 - Failure to provide or delays in providing standard reports and documents
 - Records not maintained at the credit union
 - Providing copies and not source documents
 - Inactive supervisory committee
 - Lack of, unacceptable, or non-independent audit or verification
 - Inadequate internal controls over information systems
 - No internal review of override of non-financial reports



NCUA Examiner Guide Red Flags

- Operational Red Flags (continued)
 - Bank accounts frequently overdrawn
 - Large amounts of cash in transit
 - High volume of excessive transactions
 - Use of borrowed funds in spite of cash balances
 - Lack of a fraud policy
 - Extravagant management or employee lifestyle
 - Low return on assets
 - Payment of above market dividends to attract deposits



When Should an Institution Consider Consulting a Forensic Accountant?



When you have any indication of something “funky”.



When the internal controls environment is weak.



Turnover at the Board level and other key leadership roles.



Key internal controls



Key Internal Controls

- Management has monitoring controls in place for all key areas at the credit union
 - Documentation of controls and key monitoring reports are in place
 - There is a validation the controls are functioning
 - Internal audit
 - Reporting as determined necessary
- Management sets a zero tolerance for fraud at the credit union
- Credit Union has fraud policy
- Credit Union has a whistleblower hotline



Key Internal Controls

- Credit Union requires rotation of duties
 - Periodic rotation
 - Mandatory vacations
- Credit Union has a process in place to respond all findings from examiners, internal audit, and outside third parties
 - All third parties including:
 - Contracted internal audit including AML/CFT and ACH
 - Loan review
 - Bonding company
 - Tracking process in place with report of open items maintained
 - Identification of situations where management has accepted risk





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