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## To Catch A Thief – Detecting and Preventing Internal Fraud in the Banking Industry

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- According to the Association of Certified Fraud Examiners 2010 Report to the Nation on Occupational Fraud and Abuse, the industries most commonly victimized by fraud were
  - banking and financial services (16.6% of cases)
  - manufacturing (10.7%)
  - government (9.8%)
- The banking/financial services industry had the highest number of cases reported, with a median loss of \$175,000.
- There is a huge cost of fraud that isn't easily measured. Fraud is a full time job – the real job goes undone.

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- One way occupational frauds differ from other forms of theft is that they are generally ongoing crimes that can last for months or even years before they are detected.

#### Common Myths

- Decent people won't commit fraud
- Prosecuting fraudsters deters others
- Fraud goes undetected and is well concealed
- Auditors are doing all they can to detect fraud

#### Characteristics of a Fraud Culprit – In General

- In a position of trust
- Has a family
- Motivated by some need
- Involved in community/charity
- Able to rationalize action

### Conditions Conducive to Fraud by Executives

- Weakness in the system of internal controls
- Poor maintenance of records in file storage
- Limited or no review of employee accounts
- Lack of board involvement or weak audit committee
- Decisions made by one dominate individual
- Frequent deviations from policy

### A Few Red Flags

- High personal debt
- Living beyond one's means
- Gambling/alcohol/drug problem
- Feeling of being underpaid
- Secretive, territorial
- Placing too much trust in key employees

## Accounting Frauds

### Inappropriate Uses of "Suspense" Accounts

#### Types of suspense accounts

- Loans in process
- Interdepartmental transfers
- Currency in transit
- Due from banks

#### Deterrents

- Daily supervision and approval by supervisor
- Required follow-up on stale items

## Improper Use of Expense Accounts

### Requesting reimbursement for

- Fictional expenses
- “Photoshopped” receipts
- Changed amounts

### Deterrents

- Empower expense reviewer to follow their instincts and spend appropriate time. For example, if something looks questionable, call the vendor.
- For upper management designate another senior manager or board member as approver.

## Official Bank Checks

- Checks not cashed within 6 months are unlikely to ever be cashed
- Employee could substitute a forged proof ticket and take funds
- It appears the stale check was actually cashed

### Deterrents

- Segregate stale checks from the others in the reconciliation process
- If stale checks post, two employees should review

## Lending Frauds

### Fictitious Loans – On the Loan System

#### Characteristics of this type of fraud

- Lender will need to control all contact with the “borrower”
- Loan address is a “hold mail” or address controlled by lender
- Lender makes payments from funds from other fictitious loans
- Loan will appear legitimate

### Deterrents

- Policy against loan addresses coded as “hold mail”
- Periodic review to identify seemingly unconnected loans with the same address
  - Review should concentrate on
    - Unsecured loans
    - P.O. Box addresses
    - Made by same lender
    - Balance is under secondary approval threshold

### Fictitious Loans – Off the Loan System

- A fictitious debit entry to loan-in-process
- Offset with a credit to an end point controlled by the lender
- Entries cleared by future debit entries

### Deterrents

- Loans-in-process reconciled daily to a list of outstanding entries
- Date of entries noted with follow-up on stale items
- Independent period validation of loan-in-process account entries to loan documents
- Could also trace the disposition of loan proceeds

### Loans to Straw Borrowers

- Real estate loan made
- A false real estate appraisal is created
- The real estate is sold several times to straw borrowers for increasing amounts
- At some point loan defaults
- Bank left with a large loan supported by overvalued collateral

### Loans Made to Undesirable/Non-Credit-Worthy Borrowers

- Borrowers agree to pay a high loan fee
- The lender pockets the loan fee

### Deterrents

- All substantial borrowers should be introduced to more than one lender
- Loan committee review
- Independent review of loan charge-offs and the original loan decision

### Construction Lending

- Contractor receives a draw far in advance of completion
- Funds used for other needs and a kickback to the lender
- Contractor defaults
- Bank left with large loan balance and incomplete/over-valued collateral

### Deterrents

- Someone other than the loan officer reviews and makes disbursements

### Lapping of Loan Payments

- Employee diverts customer payments for own use
- Covers with the pattern and replacing and taking customer payments

### Deterrents

- Segregation of loan operations and the generation and mail of customer information - therefore customer would receive a past due notice and alert the bank
- Require mandatory vacations

### Anti-Fraud Framework

- Culture of honesty
- Perform fraud risk assessment
- Implement changes
- Develop an oversight process
- Fraud hotline

### Culture

- Tone at the top
- Background checks
- Reference checks
- Hiring/promotion/training process
- Recognition and reward
- Zero tolerance for fraud and misconduct

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