A CASE FOR TRANSPARENCY

For Financial Institutions and Insurers

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A CASE FOR TRANSPARENCY: FOR FINANCIAL INSTITUTIONS AND INSURERS

BACKGROUND

The significant losses experienced by financial institutions and insurers, as a result of high profile fraud cases involving cash services vendors, have graphically highlighted the need for change in the financial industry surrounding the use of vendors for outsourcing various cash handling activities.

This recent fraud activity has highlighted the illusion of cash segregation by customer accounts (in the absence of simultaneous comprehensive cash audits) as being a sound auditing principal. In other words, accounting for all customers' funds in total, at the same time, is clearly more reliable than counting individual customer accounts over time. While segregated customer accounts is an industry standard, it does not protect against the proverbial "shell game", without the use of other fundamental internal controls.

TYPICAL PROBLEM AREAS OR WEAKNESSES

There are many factors that contribute to these types of long running fraud cases, including:

1. **Customer Only Audits** – Customer only audits of cash vaults allow frauds to perpetuate by not detecting the "shell game" that is typically played with customer funds.
2. **Poorly Written Contracts** – Poorly written contracts between the financial institutions, the Independent Service Organizations (ISOs), and the ATM / armored car service provider / carrier can lead to an environment that lacks the necessary controls and transparency to thwart fraud.
3. **Lack of Knowledge** – Lack of knowledge on the part of the financial institution regarding what standards or best practices to impose upon the service provider/carrier.
4. **Lack of Standardization** – Lack of standardization between financial institutions regarding the service provider's / carrier's vault procedures, cash storage procedures, accounting procedures, inventory management, inventory reconciliation, and inventory access controls.
5. **Inadequate / Irregular Annual Reviews** – Inadequate and inconsistent recurring / annual reviews of the vendor's financial status.
6. **Recognize "Red Flags"** – Failure of financial institutions to recognize "red flags" of potential fraud when conducting annual due diligence, helped perhaps by the

use of a single sourced vendor which makes termination of the deficient vendor more complicated.

7. **Lax Due Diligence** - Inadequate initial due diligence on the vendor and any related companies in some cases.

These systemic failures, alone or in combination, can permit cash service vendors to operate in an insulated environment over long periods of time. As such, financial institutions can often fail to penetrate that environment, especially if they choose to focus their attention on other areas outside of sound cash handling practices. Any of a number of causes, including irregular or improper cash audit procedures, can help facilitate a vendor's theft, fraud, or misuse of customer funds, such as utilizing customer funds to finance the vendor's own operational or personal needs. With proper controls in place, vendor perpetrated theft, fraud, or misuse of funds can be prevented altogether or at least identified early on. Unfortunately, when this is not the case the theft, fraud, and misuse goes undetected for years.

The economic consequences to related businesses and insurers go far beyond the simple direct loss of funds, but stretch out like tentacles impinging on the competitive landscape as well as creating an environment of fewer vendors handling larger and larger volumes of cash, risking further fraudulent activity and losses attributed to the next unscrupulous vendor.

ESSENTIAL CONTROLS

Three essential controls and loss prevention methods that would greatly reduce the likelihood (or at least the impact of) cash service vendor theft, fraud, or misuse of customer funds include:

1. **Third-Party Audits** – Financial Institutions and Insurance policies requiring comprehensive cash / coin and risk / compliance surveys of vendors by third-party auditors on a quarterly basis. Vendors would be required to submit to be eligible for work.
2. **Standard Audit Framework** – The creation of a common set of standards, or auditing body, will allow for comprehensive and unified audits. With all parties participating in one body, audits performed and results shared would be standardized, comprehensive, more efficient, and limit vendors to only four audits per year versus multiple individual audits from each of their customers.
3. **Vendor Certification** – The certification of cash service vendors that prescribes to more rigorous audits and best practice standards would help identify them as low risk business partners that their customers and insurers can feel more comfortable working with.

The need for the cash handling industry as a whole to embrace and apply universal, fundamental cash handling standards is imperative. Financial institutions doing business with certified vendors should be able to have confidence that these standards are being followed. There should be

absolute transparency with the vendors, so the financial institution can see that the appropriate controls are in place and consistently followed, as well as have the ability to conduct a full audit of all customer inventories, not just their own, whenever requested.

THE BIG PICTURE

In addition to the cash service vendors and the financial institutions that they serve, insurers face risks either directly from their insured, indirectly when their insured's policy is called upon when the offending vendor's policy is rendered insufficient or invalid due to principal involvement, or when steep competition requires their insured to reduce their premiums and policies to make ends meet.

All this should also provide a similar alert to underwriters. Having the proper guidelines and obtaining answers to relevant questionnaires could enable the insurer to better assess the potential risk. Furthermore, having cash audits and risk surveys with their insured, will allow for the validating of questionnaire answers, monitoring of potential risk areas, and the creating of better foundations for premium reductions based on positive performance. Lower risk to the insurer, lower losses and premiums for the assured, and lower premiums to the insured customers, equals greater confidence for the insurer that they have properly calibrated the risk potential of the insured, and greater customer confidence that they have selected the right vendor for outsourcing their cash handling activities.

CASE STUDY #1 - A DOMINO EFFECT

The economic consequences to related businesses and insurers go far beyond the simple direct loss of funds. Case in point, it is believed that in a recent fraud the vendor pursued their fraud to shore up their own business. As the vendor continued to lose money, more money was taken from customer accounts. Because the vendor could not afford to lose customers which would have rapidly accelerated the detection of its fraud, the vendor appeared to have kept pricing to customers extremely low (so low that it may have been unprofitable), thus artificially driving down pricing in the market, preventing competing businesses from capturing their market share, and also weakening competitors who had to follow the vendor's pricing lead to keep their own customers. In this case, it appears that the vendor's fraud was supposedly enacted due to losses from their business line. If competitors are also forced into a loss position then the probability of like fraud occurring there also increases, creating a domino effect. While competition is healthy, illegal competition is destructive.

CASE STUDY #2 – A GAMBLER'S STORY

James was a successful Property Manager specializing in management for condominium owners' associations. He had a winning personality, gained trust easily, and over 15 years or so, built a following of several Home Owners' Associations (HOAs). It didn't hurt his clout and prestige that he was also a real estate broker. As a Property Manager, his firm was in charge of all of the financial operations of the HOAs under his management including the collection of dues and payment of expenses. He reported regularly to the many Boards of Directors, elected by the various condo owners to run their affairs and hire worthy managers. James also provided the data to the outside accountant who did the taxes for the HOAs and prepared the financial reports.

However, James did not handle his personal life as successfully as his business. A severe gambling habit was his downfall. One particular year, he later would say, was just a haze of betting on everything from sports to card games and slots. When his own savings ran low, he began to 'borrow' funds from the various HOAs he was managing. He was so confident in his gambling ability that he was sure he would pay the money back. Instead, he dipped deeper and deeper into his clients' funds to cover his losses. To hide his thefts, he co-mingled funds of the HOAs under his management. Money from one association went to cover expenses of another. His 'borrowing' evolved into a Ponzi scheme. Eventually, the bank began to notice patterns of inter-account activity that disturbed them. Inquiries led to the bank ordering James to close all of his HOA accounts and leave as a bank customer. By that time there wasn't enough money coming in to cover the obligations of the HOAs and his scheme came crashing down. At the end of his run, the HOAs were out over $1,000,000.

This is a classic example of what happens when there is no separation of duties. The HOAs gave James the authority to collect dues, make deposits, write checks, and reconcile the bank statements. When asked for information he provided his own spreadsheets. The HOAs never believed someone like James would steal their money. Looking back, they could have averted the problem by being more proactive in their finances and not giving James so much authority.

Now divorced, his savings depleted, and employed by doing odd jobs for minimum wage, James lives in a small efficiency apartment alone. Although he was ordered to pay restitution, it is highly doubtful he will ever pay back the money that he 'borrowed'.

CASE STUDY #3 – THE PRESIDENT OF THE BANK

The initial call came on a Friday before Memorial Day Weekend. The Chairman of the Board ('COB') just found out that a $500,000 check cleared his bank and the bank called to advise him that he needed to activate the Company's line of credit. The COB was quite perplexed; he understood that he had adequate cash for the month. The President of the company, who was a non-owner, was out of town on a long weekend and wouldn't be back until Wednesday. The COB (and 100% shareholder) called his attorney with significant concern in his voice, "What could have happened to the money?" he asked. The attorney called on his trusted forensic accountant (even though it was a Friday afternoon on Memorial Day Weekend).

On Saturday morning, a team of forensic accountants arrived on the scene. Together with the COB, they went through the books and records of the company, as well as the office of the President. What they uncovered initially showed that the $500,000 had been sent as a cashier's check to an attorney in another state. Further, there were additional payments being made by the company that did not appear to be authorized by or for the benefit of the company. The forensic accountants continued through the weekend and Tuesday morning. By Tuesday afternoon, through the utilization of data extraction software and old-fashioned hard work, they had determined that a total of almost $1.4 million had been spent strictly for the benefit of the president of the company.

During the course of the weekend, other facts were gathered. The president had previously entered a 'no contest' plea on a criminal charge of fraud in another state. The underlying issue related to a defalcation of clients' funds (the president, although not practicing as such, had previously been a certified public accountant). News articles relating to the prior crime had been located over the weekend and were in the attorney's hands.

Early on Wednesday morning, a meeting was convened with corporate counsel, the HR Director of the company, the forensic accountants and, upon his arrival at the office, the president. The president was escorted into the conference room and an interview was initiated by corporate counsel and the forensic accountant. For almost two hours, the inquiry moved forward very slowly with the president providing information based on what he most likely believed the attorney and the forensic accountant had already determined. After approximated two hours, he asked if he could use the restroom. He was escorted to and from by the guard the company had hired (the guard had also deactivated the president's car upon arrival at the company, without the president's knowledge - it was a company-leased car).

When he returned to the conference room he sat down and said, "I guess you probably know almost everything." He then began to cooperate and went on to provide information with regard to the majority of the issues that had been uncovered:

- The $500,000 had been sent to an attorney in another state as part of the final restitution requirement of his prior 'no-contest' plea.

- The majority of the remainder of the funds (approximately $800,000) that had been spent had been 'authorized' by himself as well as by the Controller of the company, and related to items that included maintenance and expansion of facilities at his private home, cell phones, and other accoutrements for his wife, his daughter, and two girlfriends, various vacation trips that included in some cases his wife, and in other cases one or more of his girlfriends, and an interesting scheme whereby he obtained bank cashier checks in the amounts of $100 and utilizing photo copies of the checks, submitted them as reimbursable expenses for 'casual labor'. These totaled almost $80,000 over the course of several years.

The Company was subject to this debilitating and drastic fraud because internal controls were not properly in place. The Chairman of the Board had put complete faith in the president whom he had hired. The president used his position to 'bully' the controller and other individuals into either approving payments on his behalf, and / or simply looking the other way. While the end of the story would appear to be a $400,000 loss to the company (the original defalcation totaling approximately $1.4 million less the $1 million in fidelity bond insurance recovery) the cost was far greater:

- In addition to the $1.4 million loss, the company incurred almost $100,000 of additional professional fees,
- One week after discovering the defalcation and having had the meeting with the president in the interview as noted above, the chairman of the board died of a massive heart attack which occurred on the floor of the plant, and
- The company was subsequently liquidated.

The need for proper internal controls and the willingness on the part of top management to review transactions even for a high level COO or president are paramount in order to avoid the potential for disaster.

By David H. Glusman, CPA, DABFA, CFS, CrFA

CONCLUSION

According to the 2012 edition of its *Report to the Nations*, the Association of Certified Fraud Examiners (ACFE) estimates that fraud costs businesses worldwide almost 3.5 trillion dollars a year, amounting to approximately five percent of all revenues! What's even more alarming is the fact that occupational fraud can often continue for years before it is detected. In short, employee theft is an equal opportunity offender – it happens in large organizations and small, for profit and not-for-profit, public and private companies – no organization is immune.

The Fraud Triangle describes the three conditions that must be present for a fraud to occur: Opportunity, Incentive, and Rationalization. The hard truth is most organizations don't learn of the warning signs associated with these conditions until it is too late – the event has already happened and they are now trying to piece it, and their reputation, back together again.

The information contained in this white paper is designed to present some of the challenges that businesses face in fighting fraud, provide examples of potential vulnerabilities, and stress the importance of applying essential policies, procedures, controls, and safeguards that can significantly reduce both the likelihood and severity of loss relating to employee theft and fraud.

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