



# The Lessons of Fraud

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**T**HE NUMBER OF FRAUDULENT activities has continued to increase in the 21st century following the trends of the 1990s. Significant cases such as Enron, WorldCom, and others drew the attention of the media. But fraud affects small companies, as well as banks and other financial institutions, to an even greater degree.

Small companies are at greater risk for fraud because they are usually unable to afford the costs associated with effective internal control. The costs of hiring an internal audit staff person, implementing internal controls, and purchasing associated software or computer equipment can be prohibitive.

In a recent study, the Association of Certified Fraud Examiners (ACFE) presented findings from a number of cases reported by its members. In the ACFE “2006 Report to the Nation on Occupational Fraud and Abuse,” banks and other financial services organizations incurred a median loss of \$258,000 for each fraud. The largest percentage of cases for these organizations involved cash larceny (29 percent) and noncash schemes (15.5 percent). Banks generally used external audits (93.2 percent), internal audits (73.6 percent), or fraud training (58.1 percent) to help deter fraud. Nonetheless, bank fraud still occurs. (NOTE: The study defines occupational fraud and abuse as “[t]he use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s

resources or assets.” The complete text of the study may be found at [www.acfe.com/fraud/report.asp](http://www.acfe.com/fraud/report.asp).)

Listed below are a few precautions with examples illustrating simple steps that could have limited the extent of fraud in each case.

## Trust But Verify (Soon)

As a special agent with the Federal Bureau of Investigation (FBI) for a number of years and as a forensic accountant, I have encountered a number of instances in which banks did not verify collateral in a timely manner. In one such case, a loan applicant listed on his application a significant parcel of land, which he valued at \$1.5 million. Because of other assets, most of which would have been significantly harder to verify, and the perceived net worth of the customer, the bank was willing to take the customer at his word. Less than 18 months later, the customer defaulted on the loan.

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In the ensuing investigation, the bank discovered a number of misstatements by the customer on the loan application. The most significant asset, the land parcel, was reported to be worth significantly less by a professional appraiser when an appraisal finally was ordered. The customer explained the value listed on his application was based on his conversations with other landowners in the area. Whether that statement is true or not is a matter of speculation, but a timely appraisal would have discovered the overstatement.

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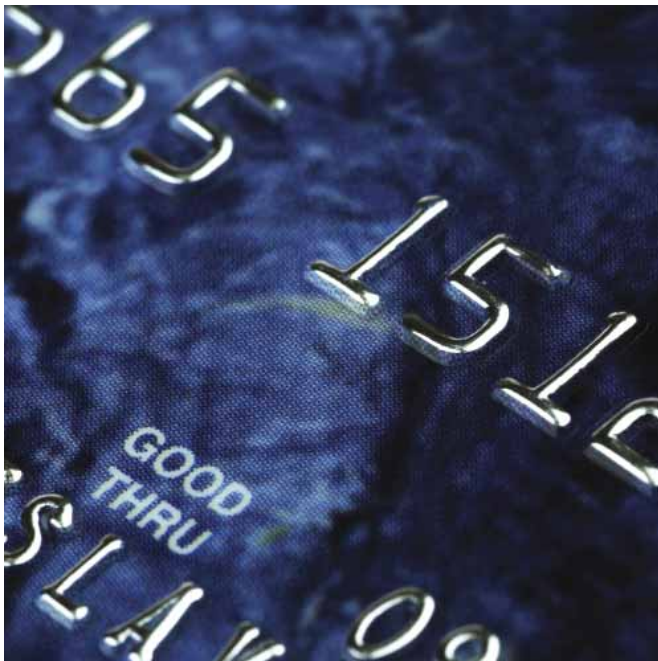
■ **Lessons of Fraud** continued

Also, a title search revealed the customer was not the sole titleholder on the property. The customer had transferred half his interest in the property when he began to realize his business was not going well. The customer failed to notify the bank of the transfer and even listed the entire value of the land as an asset in subsequent statements of net worth to the bank. A few dollars and some time invested in an appraisal and a title search would have saved the bank a significant amount of attorneys' fees and court costs.

In another important case, a lending officer made draws on lines of credit (LOC) and used falsified collateral documents as the basis. The bank discovered the false document when, after several years, it demanded verification of the collateral. Too late, the bank learned the collateral was nonexistent. The bank then incurred substantial costs uncovering the full extent of the fraud, which had been ongoing for years.

**Talk to the Customer**

It sounds simple, but banks run the risk of fraud if a customer is not aware of his or her account transactions. Recently, a bank was the victim of fraud by a senior lending officer who was drawing-down on several LOC. Another lending officer uncovered the fraud when he noticed the due dates had been extended for several notes during a physical inspection of the files. The fraudster had found a way to circumvent the bank's internal controls, which normally would have alerted the internal auditor when a loan was extended.



In this case, the fraudster changed the due date by accessing the loan through the new loan screen of the bank's lending system. If the fraudster had changed the due date through the loan-edit screen, the change would have triggered an alert and would have been included in a report reviewed by the internal auditor.

The fraud would not have been possible without the bank's policy on LOC: not sending out periodic statements to its customers stating the balance due. Customers never knew the amount of their LOC had been increased, that a draw had been made from their LOC, or that the due date of the LOC had been extended. This policy allowed the fraud to continue for several years.

A periodic statement to the customer or a request for verification of material aspects of the loan by the customer could have prevented this fraud or significantly reduced the loss to the bank. As an alternative to a statement, the internal auditor could verify the material aspects of randomly selected loans. Also, a physical inspection of a loan file for loans outstanding beyond a certain period of time—in this case, one year—could have led to the discovery as well.

**Heed Warning Signs**

In hindsight, warning signs of fraud always exist: the new expensive car or house, the new home addition, expensive vacations, or even frequent trips to a casino. The reasons for the fraud are not always clear and often may not manifest themselves at work, such as a gambling habit. But, there always are signals that, if researched, may uncover the fraud early.

In a recent case, a company had discovered its longtime business manager had been convicted of embezzlement in his last position. The company failed to conduct a background check during the hiring process. After a second anonymous phone call about the business manager's background, the company learned the truth. The first anonymous phone call had been dismissed without serious consideration. The second, however, caused a more detailed look into the person's background. The conviction was confirmed by a short phone call to the county court. Next the company needed to address a bigger issue: Was this person stealing from them?

After spending several days reviewing company records, several checks were identified without any corresponding documentation. The fraudster was confronted with the evidence and subsequently confessed to the embezzlement. The warning sign dismissed by the company—the anonymous phone call—could have halted the embezzlement several months sooner.

## Extraordinary Service for Extraordinary Members.

Warning signs are all too apparent after the fraud has taken place. A close watch and good follow-up can help save a company from incurring hefty costs in time and dollars.

### The Rules Apply to All

Often there is a reluctance to investigate the warning signs when the person occupies a position of influence within the company. The typical fraudster is an older, well-educated male with no criminal background and is often one of the most trusted employees. This trust and background usually allow the person to ascend to a position of influence and control. By virtue of the position, others within the organization are reluctant to question the directions or actions of the fraudster. The position also permits the fraudster to operate without significant oversight.

In the earlier case, the lending officer who had made draws on the LOC of customers was the senior lending officer. He began making requests to have the loan dates changed and credit limits increased without much resistance. When questioned later, the staff person who had made the changes explained that since the request came from the senior lending officer, it was not felt the request could be questioned.

In another case, a son of the bank president was drawing from several different LOC and no one questioned him because of his relationship to the president. The reason for the fraud was a gambling habit unknown to anyone at the bank. While there were numerous signs this activity might have been questionable, others were reluctant to question it.

The key to prevention is this: The rules should apply to all. A fraud investigation cannot take place without the support of the organization's management. Support



for reviews and/or audits must start at the top. Without management's support, internal audit staff will be reluctant to question the actions of senior staff who are the most likely to commit the fraud.

### Fraud Prevention Summarized

Unfortunately, lessons such as these are frequently learned the hard way. Occupational fraud is pervasive in our society, and banks and other financial institutions can be the unwitting victims.

Some ways to prevent financial institution fraud are, first, to verify collateral sooner rather than later. Verify collateral at least annually to help prevent potential loss. Second, make sure your customers are aware of what transpires in their accounts. This provides an opportunity to rectify a bad transaction in timely fashion and help protect your institution from fraud. Third, understand and heed warning signs, no matter how small. If someone appears to be living beyond their means, you may be paying for it. And fourth, apply the rules equally to all, including top-level management. Set the right tone at the top for the whole organization and you lessen the chances for a lesson in fraud. ■

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