PAYMENT FRAUD

New ways to catch a thief

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Controlled Disbursements/Account Reconciliation

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Agenda

- 2005 fraud survey results
- The Uniform Commercial Code (UCC)
- Internal controls
2005 Fraud Survey Results

Where fraud is occurring and what’s being done about it
Introduction

- Payment fraud is on the rise, and treasury and finance professionals are taking action to protect their organizations.

- The February 2005 Association for Financial Professionals (AFP) survey sheds light on the nature and frequency of payment fraud during 2004 and the internal measures and bank services used to control check, ACH and wire fraud.

- AFP promotes awareness of actions that payments systems participants can take to guard against fraud as well as the safety and soundness of the U.S. payment system.
Survey findings

Payment Methods Subject to Fraud in 2004
(Percent of Organizations Subject to Payment Fraud)

<table>
<thead>
<tr>
<th>Payment Method</th>
<th>Total</th>
<th>Under $1 billion</th>
<th>Over $1 billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Checks</td>
<td>94%</td>
<td>86%</td>
<td>97%</td>
</tr>
<tr>
<td>ACH debits</td>
<td>34%</td>
<td>28%</td>
<td>45%</td>
</tr>
<tr>
<td>Consumer credit cards</td>
<td>14%</td>
<td>14%</td>
<td>13%</td>
</tr>
<tr>
<td>Corporate purchasing cards</td>
<td>11%</td>
<td>12%</td>
<td>11%</td>
</tr>
<tr>
<td>Consumer debit cards</td>
<td>4%</td>
<td>6%</td>
<td>2%</td>
</tr>
<tr>
<td>ACH credits</td>
<td>3%</td>
<td>2%</td>
<td>3%</td>
</tr>
</tbody>
</table>

- Four out of five organizations indicated that their largest dollar losses resulted from check fraud.
- Consumer credit card fraud was twice as likely at organizations with revenues under $1 billion.
Survey findings (cont’d)

Payment Method with the Largest Amount of Fraud in 2004
(Percentage Distribution of Organizations Subject to Payment Fraud)

<table>
<thead>
<tr>
<th>Payment Method</th>
<th>Total</th>
<th>Under $1 billion</th>
<th>Over $1 billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Checks</td>
<td>81%</td>
<td>78%</td>
<td>83%</td>
</tr>
<tr>
<td>Consumer credit cards</td>
<td>8%</td>
<td>12%</td>
<td>6%</td>
</tr>
<tr>
<td>ACH debits</td>
<td>5%</td>
<td>6%</td>
<td>5%</td>
</tr>
<tr>
<td>Corporate purchasing cards</td>
<td>4%</td>
<td>4%</td>
<td>5%</td>
</tr>
<tr>
<td>ACH credits</td>
<td>1%</td>
<td>-</td>
<td>1%</td>
</tr>
<tr>
<td>Consumer debit cards</td>
<td>1%</td>
<td>-</td>
<td>1%</td>
</tr>
</tbody>
</table>

- The median dollar amount of all payment fraud was $26,600.
- Large organizations experienced twice the dollar amount of payment fraud as smaller organizations.
- Median dollar amount of payment fraud at larger organizations was $37,600, compared with $18,100 at smaller organizations.
Survey findings (cont’d)

Internal Measures

- Organizations can implement effective measures internally to protect themselves against check, ACH and wire fraud.

- Measures are more likely to be in place at organizations with revenues over $1 billion.

- All measures listed in the survey are used to some extent by respondents’ organizations, but some are more widely adopted than others.
## Survey findings (cont’d)

### Internal Measures in Place to Guard Against Check, ACH and Wire Fraud
(Percentage of Respondents)

<table>
<thead>
<tr>
<th>Measure</th>
<th>Total</th>
<th>Under $1 billion</th>
<th>Over $1 billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Separation of disbursement and reconciliation duties</td>
<td>94%</td>
<td>95%</td>
<td>94%</td>
</tr>
<tr>
<td>Security features on check stock</td>
<td>91%</td>
<td>91%</td>
<td>92%</td>
</tr>
<tr>
<td>Dual security administrators for electronic payments systems</td>
<td>69%</td>
<td>61%</td>
<td>76%</td>
</tr>
<tr>
<td>Controlled access to payments processing areas</td>
<td>68%</td>
<td>65%</td>
<td>70%</td>
</tr>
<tr>
<td>Daily reconciliation of electronic payments account</td>
<td>63%</td>
<td>60%</td>
<td>66%</td>
</tr>
<tr>
<td>Daily reconciliation of checking accounts</td>
<td>47%</td>
<td>44%</td>
<td>50%</td>
</tr>
<tr>
<td>Separate accounts for check and electronic payments</td>
<td>46%</td>
<td>39%</td>
<td>51%</td>
</tr>
<tr>
<td>Replacement of employee paychecks with electronic pay (direct deposit or payroll cards)</td>
<td>45%</td>
<td>44%</td>
<td>46%</td>
</tr>
<tr>
<td>“Post No Checks” restriction on electronic payments accounts</td>
<td>22%</td>
<td>10%</td>
<td>33%</td>
</tr>
<tr>
<td>Separate accounts for ACH debits and ACH credits</td>
<td>11%</td>
<td>9%</td>
<td>14%</td>
</tr>
<tr>
<td>Other</td>
<td>17%</td>
<td>13%</td>
<td>10%</td>
</tr>
</tbody>
</table>
Conclusions

- Payment fraud is a national problem, considering that the majority of responding organizations suffered at least one incident of payment fraud in 2004.

- The largest percentage of reported fraud was carried out by third parties (not employees).

- Most companies have adopted basic internal fraud controls, such as separation of disbursement and reconciliation duties and security features on check stock.
  - Less than half of organizations have additional defenses in place, such as reconciling checking accounts on a daily basis, establishing separate accounts for checks and electronic payments, and placing a “post no checks” restriction on electronic payment accounts — these tend to be larger organizations.

- Internal controls and bank services (i.e., positive pay, payee positive pay, debit blocking and debit filters) should complement each other.
The Uniform Commercial Code

Establishing liability for fraud
Establishing liability/General check law provisions

UCC* 3-103 “Ordinary Care”

- A bank need not examine instruments it takes for processing, for either collection or payment by automated means, if failure to examine does not violate the bank's procedures and those procedures do not vary unreasonably from general banking usage.

UCC 3-405 “Comparative Negligence”

- Employers are likely to be responsible for the integrity of their employees and to safeguard their check stock.

*The provisions of the UCC are provided for general discussion and are not necessarily the law in the state in which the company or the company’s accounts are located. Each state adopts their own version of the UCC provisions. Please consult your own counsel for any legal advice.
UCC 3-406 “Contributory Negligence”

- The loss due to fraud may remain with the company if it fails to safeguard checks from forgery or alteration by a “reasonable commercial standard”, and that failure to safeguard contributes to the forgery or alteration.

- Both the bank’s and the company’s liability for the loss, would be determined on a comparative negligence standard so if the bank exercised ordinary care and the company acted with negligence, the company would be liable for the loss.

UCC 4-406 “Reasonable Promptness”

- A period of time in which the customer has the duty to discover and promptly notify the bank of unauthorized signatures and/or alterations of checks on the account.

- Banks establish a shorter time limit through their account terms, usually 30 or 60 days.

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Obligations under the UCC

- **Issuer** — Examine all bank statements and listings with reasonable promptness

- **Payee** — Employers responsible for fraudulent endorsements by employees

- **Depository bank** — Warranty of endorsement, signature authentication, that information has not been altered and MICR encoding liability (modified by both Reg CC and clearinghouse rules)

- **Paying bank** — Pay or return by midnight deadline

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Internal Controls

Proactively preventing fraud
Defining internal controls

Internal controls are essential to “good” management and can be defined as safeguards that provide reasonable assurance that things are “going as planned.”

The five components of internal control are:

1. The control environment
2. Risk assessment
3. Controlled activities
4. Information and communication
5. Monitoring

Who is responsible?
Let us consider who is responsible for internal controls within your company.

Generally, everyone is responsible!
## Key internal control components

### Control environment
- Tone at the top
- Organizational structure
- Role of the governing board

### Risk assessment
- Identify and analyze risk associated with achieving the company objectives
- Look at each department
- Assess how much risk are you willing to accept
- Set priorities accordingly

### Controlled activities
- Policies established by the governing board

### Information and communication
- Financial reporting process
- The accounting systems
- Underlying transactions
- Communicated to others

### Monitoring
- Monitoring what you have put in place on a regular basis
Implementing internal controls

- Form an internal “anti-fraud” committee
- Use prior check fraud occurrences to level set
- Match industry “best practices”
- Establish and maintain general controls
- Physical controls on check stock
  - Storage
  - Access
  - Usage
  - Dual controls
  - Policies on how check stock is ordered, received and stored
QUESTIONS?

Thank you, and please watch for our upcoming online seminar:

Image Deposit Solutions
November 9 or 15, 2005
2-3 p.m. ET