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Case Study **Open Access**

Common Frauds in Micro Finance Institutions (MFIs)

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Abstract This paper discusses most common fraud cases in Microfinance Institutions (MFIs), how these frauds were perpetrated and suggest preventive pre and post measures. Relevant theoretical framework and similar study pertaining to frauds were reviewed. A case study based approach is adopted discussing frauds and appropriate measures. The paper will largely benefit MFIs in addressing similar fraud issues by taking appropriate steps suggested in papers. The paper emphasizes on internal control, audit trail, client education, client visit and emphasis on integrating risk management and customer relationship management framework of the MFI.
Keywords *Microfinance Institutions; Frauds; Risk Management; Internal Control*

1. Introduction

Microfinance Institutions (MFIs) serves the most underprivileged clients who are ignored by formal financial sector. Nowadays most of the countries are adopting microfinance intervention as an important tool for serving the economically poor and underprivileged class and has been widely used in financial inclusion to provide tailored financial services to neglected areas. Though these interventions have registered success stories both at client and entity level, yet frauds in MFIs have been a serious threat to their long-term sustainability and hence create hurdle and obstacles in achieving the objectives of servicing the poor and broadening of financial inclusion drive. The effects of fraud can be devastating for both young and mature MFIs leading to closure and downscaling of their operations. The Association of Certified Fraud Examiners (1999) defines fraud as the use of one's profession for personal enhancement through the conscious misuse, misapplication or employment of organizational possessions or property.

Fraud is a willful act by person internal or external to the institution, usually motivated by self-gain. It can be distortion of financial statements or other records/ stealing of cash or other property. However, the critical element in identifying fraud is to determine whether it is intentional or erroneous. (Adeyemo, 2012; Adeniji, 2004; Akinyomi, 2012).

Generally fraud flourishes in an environment with complex processes and high volume of unsystematic transactions. Some of the factors identified among others responsible for (fraud in the banking sector: (a) Weak corporate governance (b) Poor accounting practices, procedures and policies (c) Lack of client due diligence (d) Weak internal control system, policies and procedures (e) Perverted social values (f) Slow and circuitous judicial process; and (g) Fear of negative publicity Dhitima, 2013; Ogunleye, 2004; Iyiegbuniwe, 1998).

2. Fraud Cases

Some of the common fraud cases perpetrated in MFIs are given below in Table 1:

Table 1: *Common Fraud MFI Cases*

Fraud Issues	How it was Perpetrated	Causes
Padding of receipt/paying vouchers	The cashier receives money from customers against loan repayment, purchase of shares, safe keeping etc., enters correct amount in the original voucher which is given back to the customer and intentionally understates the amount written in the duplicate copy thus creating a cash difference (Excess) between the actual cash received and that recorded in the duplicate voucher. The excess cash, fraudulently created is taken for personal gain. This is repeated in continuation and remains unnoticed for some time as the daily physical cash count were agreed to the total amount in the duplicate voucher also.	Lack of segregation of duties in financial transaction which can be due to MFIs bid to lower their operational cost so as to enable them offering low cost financial services driven by social goals. Consequently the tradeoff between lower operations cost and adequate internal control mechanisms leaves the manager out in the field for marketing or loan collection whilst the cashier is left alone to man the office hence giving him the leeway to perpetrate such mischief. Furthermore, most customers of rural financial institutions are illiterate implying that the filling of withdrawal and deposit slips is mostly done by the cashier thus giving them the advantage to perpetrate such fraud.
Conversion of cash collected in the field	Similarly as in point 1 discussed above, the manager goes out in the field in most cases alone for marketing and loan collection, in the process he collects cash from customers in respect of loan repayments, sale of shares, safe keeping/deposits etc. Manager enters the correct amount in the original voucher given to the customers and intentionally understates the amount written in the duplicate copy thus creating a cash difference (Excess) between the actual cash received and that recorded in the duplicate voucher which is again converted for personal gain. These collection manager after their return to the MFIs only hand over the total cash as recorded in the duplicate voucher.	The manager left alone jeopardizes the dual control over the cash collected in the field. This leaves him with the leeway to defraud the institution and its customers that are mostly illiterate who cannot decipher transaction processes. Furthermore, the lack of client education allows client transaction manipulations.
Cash in vault malpractice	The co-safe custodian in the MFIs negligently hands over the second key of the safe to the manager whilst he traveled out of the MFIs community for some days. This leaves the manager with both keys to the safe thus giving him total control of the cash in safe which was in aberration to the internal control risk management of dual control. This gives the manger unrestricted access to pilfer the cash from the safe.	The dual control over the safe was compromised due to the negligence of the co-safe custodian who was a joint key custodian to the safe by giving his key to the manager thereby giving him unrestricted access to the safe. Lack of trained operational personal in MFIs operations.
Ghost loans	The manager/loan officer created loans in the name of the bank's customers and converts amount involved for personal usage. He succeeds in covering up this fraud through the creation of additional new ghost loans whilst at the same time falsifying repayments of the previous created ghost loans.	Fraudulent intent by the manager/loan officer. Negligence of the Credit Committee in the monitoring and disbursement process. Lack of field verification exercises of the customers regarding loans

Staff and Customer Loan Collusion	The loan officer persuaded customer(s) to access loans jointly that is shared between them. Though the credit files were only created in the name of the customer, who actually paid his/her own part of the loan whilst that of the loan officer was in default. Upon field verification with the customer the above was revealed.	Lack of integrity of the Loan Officer combined with lack of pre-disbursement verification. Lack of customer's education.
System Manipulation	The MIS officers together with another staff colluded to manipulate the database and a customer's account was credited with certain amount. At one point to withdraw the money with a cheque instrument that was issued falsely to the said customer. The instrument was used by falsifying the customer's signature to withdraw the money. In another event the colluded staff contracted the customer and involved him in the fraud by allowing him to withdraw the money from his account. This involves the entire customer and other staff involved.	This was a collusion to intentionally defraud the bank
Improper and inadequate segregation of duties	The cashier who collects the daily deposits was asked by the accountant to seal the cash collected in bundles by denominations and the cashier intentionally mixed the big notes with some smaller notes and then colored the side of the notes to give the color of the big note and then bundle it. This act went unnoticed and the cash was treasury in the vault. This was unveiled when treasury was to pay out a customer.	The segregation of duties was found inadequate and improper as the cashier who collected the deposit should not have checked and bundled notes independently.
Conversion of deposits, share purchases, and loan repayments.	The Customer Service Officer who was responsible to assist uneducated customers filling out their withdrawal and deposit slips for payments in respect of shares, loan repayments and deposits becomes so acquainted to the customers to the point that they trusted her to withdraw and deposit on their behalf and collected their slips or cash later. This was done especially when the bank is crowded and the customers got impatient to wait. The Customer Service Officer took advantage of the trust of the customers and she subsequently converted the cash to be deposited and withdraw on their behalf for her personal usage. She concealed her dubious act through falsifying slips for deposits, shares etc. In the case of withdrawal she suppressed the cash by giving different version of excuses to the customers. This was only revealed when she fell ill and was absent for few days. Diverse complains were made to the sitting staff who informed the management.	Breach of internal controls regarding the receipt of deposits. Failures to use a deposit register at the Community Bank. Staff rotation which is a control mechanism was not employed in such role. Management supervisory role of the banks daily operations was lacking.
Manipulation of financial data.	The accountant deliberately double counted the debtors figures in the Statement of Financial Position in order to balance off the asset side of the Balance Sheet to the Liability side. After knocking off the doubling effects of the debtors figure, it was realized that the asset side is in shortfall of the knock off amount of the debtors figure, implying either cash or other assets has been defrauded. In essence, fraud was concealed through the double posting of the debtors figure.	The manual system of operation created an ideal opportunity for manipulation of financial data The manager did not understand how to monitor his financial statement and its elements. The Accountant was handling several transactions single handedly thus breaching internal control principles.
Income General Ledger manipulation	Salary expense ledger account was debited and one staff account credited and subsequently transferred to another staff account purporting to be in error and then the later staff later used an instrument to withdraw the	User access right was compromised and right was used by unauthorized staff.

	money. The routing of the said amount was done with the intention to conceal the act of manipulation and fraud. In another event an income GL account was debited and cash in till ledger subsequently credited. The cash was taken out from the amount treasury by the accountant who then raised a voucher, then given to the MIS officer who ignorantly verified voucher and the accountant further instructed cashier to stamp and post transaction in the system.	Lack of integrity of the accountant and lack of understanding of basic banking transaction by the MIS officer.
Kickbacks in the loan administration	A review of the loans performance report of a bank reveals numerous non-performing sticky loans. Field verification of the loan clients was done to ascertain the reason for the high default and existence to the loans client. A shocking response about the loans officers accepting kickbacks from client was gathered and in some cases was used as pre-condition by loans officer for customers to access loans. Though evidences were corroborated from various loan clients yet it was very difficult to verify as evidences were hard to get and in some cases customers were not willing for any legal prosecution.	Intentionally done for the personal gains at the expense of ethics and reputation of the institutions

3. Fraud Risk Management

Fraud risk management is designed to identify and develop preventive actions for the business to reduce risks arising from the inherent and potential cases of corporate operations (Churchill Craig and Dan Coster, 2001).

The establishment of internal control mechanism is as paramount as management attitude towards setting the right tone for the controlled environment. It implies that management must ensure that the whole process of internal control is embraced right throughout the organisation at all levels (i.e. operational, middle and management staff). The alignment of management attitude with the internal control mechanism means management must own and take responsibility of the internal control processes. Management in ensuring their commitment to this utmost responsibility must establish a well-structured holistic sanction grid with detailed offences and penalties. Setting up such redress system for breach of controls can be effective in setting the tone for the control environment within the institution especially when the application of the sanction grid is done fairly, equitably and on time.

One of the major causes of increased fraud cases in MFIs is due to Board lack of capacity to understand internal control issues. Internal control that is central in the risk management function of the Board is in most cases neglected either because of Board incapacity in understanding internal controls issues, or because of compromise or lack of commitment to their role.

The board should give paramount attention to the internal audit function of their organisation as it seek to provide the status of the organistion's processes at any point in time under the review period. Board must be well exposed to trainings that will capacitate them to understand their role in providing the most needed oversight to their institution that is required of them by their shareholders and other stakeholders. Few measures to avoid the fraud issues are as follows:

- The Board of Directors and the management must set the tone for an effective control environment.
- They must lead in creating a culture of honesty and zero tolerance for fraud by imposing sanctions that are swift, decisive and consistent.

- The Board and the Manager will take actions that send a clear message that violation of any kind (i.e. of credit policies, accounting policies and internal controls etc.) are taken seriously and will not be tolerated.
- Management must put in place clear accounting systems and should follow best practices in accounting to promote transparency.

4. Specific Measures

4.1. Policies and Procedures Manual Development and Review

As far as possible, every activity within the MFI's operations must be guided by policies and procedures without leaving unreasonable grey area for manipulation. Key policies and procedures manual that are relevant for MFI's operations are the Credit Policy and Procedures Manual and the Accounting and Finance Manual which detailed the steps required for each transaction that must be adhered to. Manuals reduce confusion and ensure standard operating practice. The manuals should be regularly updated to provide for changes in the business operations and environment and must be made accessible to all employees.

To ensure accountability at all levels, all employees must have clearly defined and documented job descriptions. Management can refer to job descriptions to assess and discuss employee performance in order to reinforce individual accountability.

In instituting policies and procedures, the Board of Directors and the Management of MFIs may adopt all or any of the following control measures (Campion Anita, 2000):

a. Segregation of duties – involves separation of responsibilities for two or more tasks that could result in error or encourage dishonest behavior if only handled by one employee. This also ensures that each person's work is checked by another.

b. Authorisation Limits – setting of parameters for transaction approval at the different level of authority and role.

c. Signature requirements – to protect the institution from unauthorized transactions

d. Physical controls – to ensure the security and existence of assets reported in the accounting books

e. Crosschecks/Spot Checks – as an assurance that policies and procedures are respected

f. Dual controls – to ensure that no employee has total control over the assets of the MFI, by having at least other employee checking or approving transaction or in custody of an asset.

As much as possible, policies and procedures for every aspect of operations must be written and communicated to all employees to avoid misinterpretation. As an integral part of preventive control, policies and procedures must be adhered to or implemented by all staff as stated. Some very specific measures are suggested below:

4.2. Credit Folder

Incomplete or missing loan documents are sign of ongoing fraud issues. The credit policy should clearly mention type of documentation required and documents checklist must be in credit folder. The completeness of credit folder shall be one of the criteria before disbursement to be verified by accounts unit/department. Once the credit is granted, the credit folder must well secured and under dual control. Any exception regarding the completeness of the credit folder must be follow up as a means of verification. Security document must be properly vetted and perfected to prevent against the use counterfeit collateral. The incompleteness of credit folder of customers can be a source of suspicious loans; therefore great attention should be paid to it to ensure the documents therein are not fictitious.

4.3. Client Visit

A client visit is necessary step in mitigating risk associated with ghost loans. The immediate supervisor must interview all the clients before disbursement may visit a sample of clients of all new loans issued. However the internal auditor or compliance officer shall do a sample visit to the clients. Sample of loan client should be selected from the each loan aging category by using stratified random sampling technique. These selected clients should be visited for verification and possible recovery action. This is important because an MFI employee may make the monthly payments in a variety of ways to conceal a ghost loan. In some cases, he/she would take an advance from one loan and use it to make payments on several other loans via journal-voucher transfers. At other times, he/she would take a loan advance in cash and make cash payments on the loans coming due. He /she can also purchase bank money orders with stolen funds and mail payments to different branch offices of the MFI to ensure that other employees processed transactions on the accounts. The client visit will enable MFIs to identify fraudulent practices by loan officers or non-compliance to credit policies at early stage of the fraud (Gombarume, 2014).

4.4. Clients Education

Most of the MFIs are operating in rural areas where greater proportions of clients are illiterate. Client's education is major area that is being ignored by most MFIs. The client shall be educated on the do and don'ts of their dealings with the MFI right from the acquisition stage in the loans process. The policy related to collection of cash from clients in field shall be very clear and the client should be fully aware of their rights and responsibility in the process. If the rural infrastructure regarding telecommunication is in place, the MFIs should discourage loan officers disbursing to and collecting cash from clients in field, by using mobile money technology for repayments and disbursement.

4.5. Management Information System Software

Appropriate software and parameters setting is key in preventing fraud is MFIs. Internal control policy and procedures should be integrated at the time of procurement of the software. Access, posting and approval rights that are at the core of the internal control mechanism of a software needs to be streamlined to the risk management framework and policies of the MFI. An independent system audit shall be conducted to verify the features and controls in the system. The reversal of account, movement from GL to customer account shall be done with only multi-layer approval.

4.6. Data Importation

The MFIs changing from one software to another or from manual to software needs to manage the process very meticulously. There shall be defined data migration policy shall clearly spells out the approach being adopted. A complete vouching of customer balances shall be done to avoid fraud and errors.

4.7. Suspense or Transit Account

Regular review of the suspense, in transit, other assets and other sundry GL accounts will serve as major deterrent in preventing fictitious transaction therein. Unchecked suspense/in transit GL usually serve as a breeding ground for the concealment of the fraudulent transactions ranging from ghost clients to unauthorized expenses. Management should require a weekly report containing clear description of transaction details of suspense/in transit GL account and reconciliation, with explanation of un-cleared transactions. Subsequently, internal audit department should review the report.

4.8. Bank Reconciliation

There must be a routine process (preferably monthly) that explains the difference between the bank balance as in an MFI's bank statement, as supplied by the bank, and the corresponding amount shown in the MFI's own accounting records at a particular point in time. The process is a key risk management procedure that enables the MFI to identify irregular transactions in their account with their banks. Bank Reconciliation ensures timely and appropriate action in correcting and safeguards the liquid asset of the MFI.

4.9. Audit Trail

MFIs must ensure that an adequate system that can track the detailed transactions relating to any item in an accounting record is in place to allow for charging responsibility for any query. The MFI's information system software must be capable of recording of the changes that are made to a database or file. In essence one must be able to track completely the activities of all users across the systems.

4.10. Regulatory

Regulation of Microfinancial institutions requires different set of rules and standards in comparison to conventional banking. It requires regulators to acquaint themselves with the microfinance industry from a point of view of enabling them to strive without comprising the integrity of the financial sector. The risk management system within the MFI should be reviewed before issuance of operating license. Dedicated internal audit department could be one of the requirements for granting license. In case of young and small MFIs the internal audit function can be outsourced. Requiring an audit of all loan clients each year could be burdensome and costly affair because of obvious reasons. Regulators should provide clear guidance on how to fulfill internal control requirements for a newly licensed microfinance institution and allow a reasonable amount of time for the MFI to implement these changes. Regulators shall maintain a database for the employees committed fraud in the financial sector and requires fit and proper check for the employees employed by MFIs.

5. Conclusion

Above all, zero tolerance policy and protecting whistle blowers goes long way in preventing frauds in MFIs. Control can be integrated into a risk management and customer relationship management framework of the MFI. This implies regular engagement with the customers of the MFI must be in place through client visits, suggestion box, radio programme etc. These engagements with provide adequate feedbacks regarding customer's satisfaction and other relevant concerns. This is crucial as they need to fully aware of not only the products and services of the MFI but similarly their rights and responsibility in mitigating risk of financial loss that may emanate from them or MFI's end. In doing so, the MFI can proactively identify fraud and other risk exposures that can be mitigate at the earliest possible time. Based on lessons learnt from this integrated relationship, the MFI will be better placed in making necessary improvement into the product and processes, as information collected can be studied to improve the products and procedures to reduce risk in the future.

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