Managing the Risk of Fraud in Outsourcing

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Topics Covered

• Outsourcing Overview
• Fraud & Outsourcing
• Outsourcing Risk Management
• Role of Internal Audit
What Is Outsourcing?

NO, YOU MAY NOT OUTSOURCE YOUR HOMEWORK TO INDIA.
What Is Outsourcing?

• *Webster’s Dictionary* has dropped Outsourcing
• Is it an industry?
"Outsource" is in Webster's.

Laura Hymes, 5/30/2012
Global Outsourcing Market

ITO accounts for c.65% of the total

Continuing growth rates for both ITO and BPO expected > 30 - 40%

2012 – circa $450 B

Source: ALSBRIDGE
Top Reasons for Outsourcing*

- More time to watch TV
- Focus on picking my outfits
- Throwing more tantrums
- Reading more books
- Access to scarce resources CANDY
- Integrating desserts and crafts
- Avoiding my parents

*Source: Isabella
Top Reasons for Outsourcing*

• Reducing operating costs
• Enable focus on the core business
• Improving service levels
• Improving quality
• Access to scarce skills and capabilities
• Integrating disparate processes and systems
• Avoiding needed investment

*Source: ALSBRIDGE
Processes Outsourced

- ITO – IT infrastructure Hard & Soft, Networks, Development
- BPO – Payroll, HR & Benefits Admin, Finance & Accounting, Procurement, Real Estate Administration
- Call Center – Sales, Customer Service, Tech Support
Outsourcing Trends

• “If it can be done on a computer, it can be outsourced”
• Legal Document Review, Medical Diagnostic, Registrar and Transfer Functions, Fund Accounting, Trust Accounting
• Policy Servicing, Claims Processing
• Marketing & Graphic Design, Animation
Outsourcing Trends

• Increased “nearshoring”
  – Latin America (US)
  – South Africa, East Europe (Europe)

• BPO on the rise (Technology Leverage)
  – F&A, Procurement
  – HR, Recruitment

• BPM, BPT
Outsourcing Destinations

Saving Potential vs. Talent Pool comparison for English language back-office work

Source: Everest 2008
Typical Outsourcing Process

**Decision:** Diagnostic and business case development

**Transaction:** Design and implementation

**Operations:** Performance Management and benefits realization

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**People**

**Process**

**Information Technology**
Risk Management

“The first step in the risk management process is to acknowledge the reality of risk. Denial is a common tactic that substitutes deliberate ignorance for thoughtful planning.”

Charles Robert Tremper – Author of risk management books.
Outsourcing Risks

- Strategic Risk
- Reputation Risk
- Compliance Risk
- Operational Risk
- Fraud Risk
- Counterparty Risk
- Country Risk
- Contractual Risk
- Access Risk
- Concentration and Systemic Risk
Fraud and Outsourcing*

- CC stealing customer access codes and personal data – Citibank 2005, **$350,000** was stolen.
- BPO employees use of a Client’s Internet banking IDs and PINs, **$425,000** fraud.
- Refund Fraud, created **30 dummy customers** and embezzled more than **$91,000**.
- Satyam overstatement of revenue by **$1 billion**

*Source: ALSBRIDGE*
Video

Report of Outsourcing Fraud
Fraud Risk in Outsourcing

Fraud Risks Include:
- Corruption
- Kickbacks
- Bid-rigging
- Economic extortion
Fraud Risk in Outsourcing

“Disgruntled Employees”

Fraud Risks Include:
• Asset Misappropriations
• Identity Theft
• Fraudulent Disbursements
• Vendor Fraud
Fraud Risk in Outsourcing

**Decision**: Diagnostic and business case development

**Transaction**: Design and implementation

**Operations**: Performance Management and benefits realization

Fraud Risks Include:
- Asset Misappropriations
- Ghost Employees
- Billing Schemes
- Financial Statement Fraud
- Non-Compliance
- AML, Privacy Breach
- Identity Theft
Fraud Risk Mitigation

“You outsourced the process, not the risk”

Embed a comprehensive fraud risk management program in the outsourcing process with the basics:

- Create a control environment
- Perform an outsourcing fraud risk assessment
- Design and implement antifraud control activities
- Communicate antifraud programs and controls
- Monitor the effectiveness of antifraud programs and controls
Strategic Risk in Outsourcing

Decision: Diagnostic and business case development
1.1, 1.2, 1.3

Transaction: Design and implementation
1.1, 1.2, 1.3

Operations: Performance Management and benefits realization
1.1, 1.2, 1.3

1.1 Third party may conduct activities on its own behalf that are inconsistent with the overall strategic goals of the regulated entity.
1.2 Failure to implement appropriate oversight of the outsource provider
1.3 Inadequate expertise to oversee the service provider
Reputation Risk in Outsourcing

2.1 Enhanced Due Diligence KYSP, Leverage in-house disaster recovery process as a “back in-house” measure
2.2 Customer interaction is not consistent with overall standards of the regulated entity
2.3 Third-party practices not in line with stated practices (ethical or otherwise) of regulated entity
Compliance Risk in Outsourcing

**Decision:**
Diagnostic and business case development

**Transaction:**
Design and implementation

**Operations:**
Performance Management and benefits realization

3.1, 3.2, 3.3

3.1 Privacy laws are not complied with
3.2 Consumer and prudential laws not adequately complied with
3.3 Outsource provider has inadequate compliance systems and controls (SOX, AML, Privacy, etc.)
Operational Risk in Outsourcing

**Decision:**
Diagnostic and business case development

**Transaction:**
Design and implementation

**Operations:**
Performance Management and benefits realization

4.1, 4.2, 4.3, 4.4

4.1 Technology failure
4.2 Inadequate financial capacity to fulfill obligations and/or provide remedies
4.3 Risk that firms find it difficult/costly to undertake inspections
4.4 Fraud or error
Exit Strategy Risk in Outsourcing

5.1 The risk that appropriate exit strategies are not in place.
5.2 Limited ability to return services to home country (in-house) due to lack of staff or loss of intellectual history
Counterparty Risk in Outsourcing

6.1 Inappropriate underwriting or credit assessments
6.2 Quality of receivables may diminish
Country Risk in Outsourcing

**Decision:** Diagnostic and business case development

**Transaction:** Design and implementation

**Operations:** Performance Management and benefits realization

7.1, 7.2

7.1 Political, social, and legal climate may create added risk

7.2 Business continuity planning is more complex
Contractual Risk in Outsourcing

Decision:
Diagnostic and business case development

Transaction:
Design and implementation

Operations:
Performance Management and benefits realization

8.1, 8.2
8.1 Ability to enforce contract
8.2 For offshoring, choice of law is important
Access Risk in Outsourcing

9.1 Outsourcing arrangement hinders ability of regulated entity to provide timely data and other information to regulators

9.2 Additional layer of difficulty in regulator understanding activities of the outsource provider
Concentration and Systemic Risk in Outsourcing

Decision: Diagnostic and business case development

Transaction: Design and implementation

Operations: Performance Management and benefits realization

10.1 Overall industry has significant exposure to outsource provider.
The Outsourcing Process

**Decision:**
Diagnostic and business case development

**Transaction:**
Design and implementation

**Operations:**
Performance Management and benefits realization

Keys to success:
- Know your baseline
- Don’t outsource the problem
- You outsource the process not the responsibility
- Know the risks and develop mitigating options
- EDD - KYSP
Mitigating Outsourcing Risk in the Operations Phase

- Conduct and outsourcing risk assessment, develop risk mitigation actions, monitor, and testing.
- Perform due diligence on the service provider to ensure technical capabilities, managerial skills, financial viability, familiarity with the financial services industry, and a demonstrated capacity to keep pace with innovation in the marketplace. EDD and KYSP
- Negotiate a written contract that is operationally flexible and that clearly articulates the expectation and responsibilities of both sides.
- Clearly define a comprehensive service level agreement for the transition, operational, and termination phases.
Mitigating Outsourcing Risk in the Operations Phase

• Incorporate HR-related issues in the contract.

• Clearly define expected security controls in the outsourcing contract and develop appropriate performance measures to monitor consistent application of those controls.

• Involve internal and/or external audit in the entire outsourcing process.

• Ensure that contingency plans are formulated and viable in the event of non-performance by the service provider.
Mitigating Outsourcing Risk in the Operations Phase

- Agree on transition methodology.

- Monitor the transition process closely.

- Test all systems and business continuity procedures and programs prior to go-live date.

- Involve the human resources department early in the process when staff is to be released or transferred to the service provider. Proactively communicate with staff. Implement a comprehensive communications program.
Mitigating Outsourcing Risk in the Operations Phase

• The board of directors and senior management must retain accountability for any outsourced activity.

• Create a management structure to establish, manage, and monitor the outsourcing arrangement.

• Retain key individual from the outsourced function to manage and monitor the outsourcing arrangement, and to provide future strategic direction.
Mitigating Outsourcing Risk in the Operations Phase

- Monitor the relationship actively, respond to problems and issues aggressively, employ escalation procedures promptly, and engage in conflict resolution.

- Identify objective and quantifiable performance measures that are well specified, relevant for the supported business units, mutually agreed to, and are readily comparable with established criteria.

- Periodically review, renegotiate, and renew the contract. Reset target service levels annually.
Role of CFE

• Advise management and those charged with governance of the outsourcing risks and potential impacts in the outsourcing process
• Leverage enterprise knowledge
• Obtain an oversight role in the outsourcing steering committee or project leadership group
• Establish an active role in the development of the outsourcing risk assessment
Role of CFE

- Facilitate the outsourcing risk assessment sessions
- Assist in the development of controls based on its understanding of the outsourcing risks
- Review and challenge of the relevance of outsourcing risk-mitigating controls identified to the identified risks
- Advise on the development of monitoring controls that integrate with continuous auditing monitoring programs
Conclusion

Outsourcing companies are constantly working on new technologies and processes to improve what you did in-house and add value. However, these need to be continually supported by the more traditional methods of:

• Conduct outsourcing risk management
• Rigorous management oversight
• EDD KYSP
• Leverage in-house disaster recovery plan
Thank You

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