*ECONOMIC AND FINANCIAL RESEARCH LETTERS*
***Research Article | Volume 5 | Issue 5 | Apr 2025***
*Received: 12 Mar 2025 | Revised: 30 Mar 2025*
*Accepted: 12 Apr 2025 | Published Online: 17 Apr 2025*

# Financial Fraud Detection through K-means Clustering-based unsupervised Learning

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**Abstract:** Financial fraud is a prevalent issue that poses significant economic threats globally. With the rapid advancements in technology, traditional fraud detection methods are becoming inadequate, necessitating the development of more effective and efficient approaches. The current research landscape in financial fraud detection predominantly relies on supervised learning techniques, facing challenges such as imbalanced datasets and limited scalability. To address these limitations, this paper proposes a novel approach utilizing K-means clustering-based unsupervised learning for financial fraud detection. The innovative framework aims to enhance detection accuracy and scalability while reducing false positives. By leveraging unsupervised learning, the model can detect anomalous patterns without labeled training data, thereby improving fraud detection performance and adaptability in dynamic financial environments.

**Keywords:** *Financial Fraud; Fraud Detection; Unsupervised Learning; K-means Clustering; Anomalous Patterns*

## 1. Introduction

Financial Fraud Detection is a specialized field that focuses on developing and implementing technologies and strategies to identify and prevent fraudulent activities within the financial sector. Some of the current challenges and bottlenecks in this field include the increasing sophistication of fraudsters, who continuously adapt their tactics to evade detection, the vast amounts of data that need to be processed in real-time to detect anomalies, and the need for advanced analytics and machine learning models to accurately identify fraudulent patterns. Additionally, regulatory requirements and privacy concerns add another layer of complexity to effectively detecting and mitigating financial fraud. Overcoming these challenges requires interdisciplinary collaboration, continuous innovation, and a deep understanding of both financial systems and cutting-edge technologies.

To this end, research in Financial Fraud Detection has advanced to incorporate sophisticated machine learning algorithms, data analytics techniques, and blockchain technology. Current studies focus on real-time fraud detection, anomaly detection, and developing robust fraud prevention strategies. A comprehensive literature review on financial fraud detection methodologies reveals the evolving landscape of combating fraudulent activities in the finance sector. Huang et al. [1] introduced a machine learning-based K-means clustering method that enhances the accuracy and efficiency of fraud detection by identifying anomalous patterns in financial transactions. Islam et al. [2] proposed a rule-based machine learning model that outperformed existing methods in accuracy and precision for fraud detection. Kamuangu [3] conducted a review on the application of AI and machine learning in fraud detection, emphasizing the transformation of traditional approaches. Shoetan et al. [4] highlighted the pivotal role of Big Data Analytics in detecting fraud, showcasing successful implementations and future integration with emerging technologies. Cheng et al. [5] introduced the GNN-CL model, utilizing advanced neural networks for precise fraud detection by filtering noise and reinforcing crucial information. Innan et al. [6] presented the innovative Quantum Federated Neural Network (QFNN-FFD) framework, combining quantum computing and federated learning for secure and efficient fraud detection. Meanwhile, Cheng et al. [7] reviewed the utilization of Graph Neural Networks (GNNs) in financial fraud detection, emphasizing their superiority over traditional methods in capturing complex relational patterns. Adewumi et al. [8] discussed the synergistic role of adaptive machine learning models and business analytics in enhancing fraud detection systems, foreseeing a more resilient framework in combating financial fraud. Moreover, Ismail et al. [9] and Galla et al. [10] explored the application of machine learning algorithms in enterprise fraud detection, achieving high accuracies and aiming to proactively identify fraudulent activities. Together, these studies present an array of innovative approaches and technologies that contribute to the advancement of financial fraud detection strategies. The use of K-means clustering in financial fraud detection is essential due to its ability to identify anomalous patterns in financial transactions accurately and efficiently, as highlighted by Huang et al. This machine learning-based method enhances fraud detection performance, showcasing the evolving landscape of combating fraudulent activities in the finance sector.

Specifically, K-means clustering is a powerful unsupervised machine learning technique that can be employed in financial fraud detection by identifying patterns and anomalies in transaction data. By grouping similar transaction behaviors, it helps in flagging outliers that may indicate fraudulent activities, thus enhancing risk management and security measures in financial institutions. A comprehensive exploration of k-means clustering algorithms has been conducted in various studies. Hartigan and Wong (1979) introduced the k-means clustering algorithm [11], while Kanungo et al. (2002) presented an efficient implementation termed the filtering algorithm to enhance the practical efficiency of k-means clustering [12]. Wagstaff et al. (2001) extended the concept by exploring constrained k-means clustering with background knowledge [13]. Furthermore, Huang et al. (2024) demonstrated the application of machine learning-based k-means clustering for financial fraud detection, emphasizing its superiority in adaptability and precision compared to traditional methods [14]. Sinaga and Yang (2020) proposed the unsupervised U-k-means algorithm, eliminating the need for manual initialization and parameter selection [15]. Additionally, Azzahra et al. (2024) applied k-means clustering to group sales of frozen food products, showcasing its practical implications in e-commerce settings [16]. Jain (2008) offered an insightful reflection on the evolution of data clustering methodologies, including k-means clustering [17]. Ikotun et al. (2022) presented a thorough review of k-means clustering algorithms and their advances in the era of big data [18]. Lastly, Nie et al. (2023) introduced a novel formulation for the K-means objective function, leading to an effective and efficient clustering algorithm with faster convergence rates [19]. The contributions of Likas et al. (2003) in proposing the global k-means clustering algorithm have also significantly enriched the clustering literature [20]. However, existing studies on k-means clustering algorithms still face limitations, including sensitivity to initial conditions, challenges in determining optimal cluster numbers, and difficulty in handling high-dimensional data effectively.

The work by C. Y. Tang and C. Li has been a significant source of inspiration for this study. By delving deep into the intricate details of corporate fraud dynamics within the context of Chinese A-share listed firms, the authors have extensively explored multiple dimensions and intricacies of corporate fraud phenomena, offering an essential foundation upon which our research has been built [21]. Tang and Li meticulously dissected a variety of factors contributing to fraudulent activities, providing critical insights into the nature of financial discrepancies. Their emphasis on the analysis of corporate governance structures and the influence of management practices has been especially instrumental. These insights have directly informed our approach, as we adapted their foundational findings and applied these to our methodological framework, underpinned by unsupervised learning mechanisms. The comprehensive examination undertaken by Tang and Li revealed several poignant indicators and patterns related to fraudulent activities, which are inherently latent and oftentimes require sophisticated methods to decipher and predict. Their methodological approach offered a detailed grasp of these intricacies, particularly through quantitative assessments and qualitative observations, which were pivotal in guiding our research design. The deployment of advanced statistical techniques in their research to unravel the underlying patterns of corporate fraud played a crucial role in shaping our application of K-means clustering within our present study. Moreover, Tang and Li's work highlighted the pivotal role of discrete factors such as corporate financial performance metrics, management practices, and regulatory environments, which have substantially influenced our selection and preprocessing of relevant data variables. By closely examining elements such as board composition and financial transparency, we have incorporated these into our data models, aiming to harness their indicative power in identifying fraud patterns without explicit supervision. The procedural intricacies, including data collection criteria and evaluative methods delineated by Tang and Li [21], served as a valuable framework which we have adapted with considerations for our unsupervised learning techniques, ensuring the effective detection and analysis of financial frauds. In summation, while maintaining a modest stance, it is clear that Tang and Li's revelations provide a robust intellectual backdrop that immensely facilitated the development and application of our unconventional approach to fraud detection, underscoring the indispensable role of their academic contributions.

This research tackles the pressing problem of financial fraud, which poses severe economic threats on a global scale, particularly as technological advancements render traditional detection methods increasingly ineffective. Section 2 of the study articulates the problem statement by identifying the inadequacies of current approaches, which primarily rely on supervised learning techniques. These methods often struggle with imbalanced datasets and limited scalability, hindering their effectiveness. In response, section 3 introduces a groundbreaking approach employing K-means clustering-based unsupervised learning to combat financial fraud. This method aims to improve detection accuracy and scalability while minimizing false positives. By utilizing unsupervised learning, the proposed model can identify unusual patterns without the need for labeled training data, offering enhanced performance and adaptability in dynamic financial landscapes. Section 4 presents a detailed case study to illustrate the practical application of this method. Section 5 offers an analysis of the results, demonstrating the model's effectiveness. This is followed by a discussion in section 6, which explores the implications and potential of the approach, culminating in section 7 with a comprehensive summary, underscoring the model's promise in revolutionizing financial fraud detection.

## 2. Background

### *2.1 Financial Fraud Detection*

Financial fraud detection is a critical component in maintaining the integrity and stability of financial systems. It encompasses a variety of techniques and methodologies designed to identify and prevent deceptive activities that aim to manipulate financial transactions for unlawful gains. The adoption of sophisticated statistical and machine learning models is central to this domain, enabling the identification of irregular patterns that may indicate fraud. The process often begins with data pre-processing. Given a transaction at time $t$ , represented as $v_t$ , the data can often be multivariate, such as comprising transaction amount, location, time, and other contextual features. These features are meticulously analyzed, frequently using anomaly detection algorithms designed to highlight deviations from regular patterns.

$$X_t = x_1, x_2, \dots, x_n \tag{1}$$

One fundamental tool in fraud detection is statistical analysis. Fraudulent activities often generate outlier data points in distributional patterns of financial metrics. By modeling these metric distributions, say the distribution of transaction amounts, using a probability distribution $P(X)$ , we can employ statistical tests to identify anomalies.

$$P(X) = f(x; \mu, \sigma) \tag{2}$$

Machine learning models, especially supervised learning approaches, are widely used in fraud detection. These methods require a set of labeled transactions to train a model to classify future transactions as fraudulent or legitimate. Suppose the label $y_i \in \{0,1\}$ denotes whether a transaction is fraudulent ( $y_i = 1$ ) or legitimate ( $y_i = 0$ ). A common supervised learning approach is logistic regression, which models the probability of a transaction being fraudulent as:

$$P(y = 1|X) = \frac{1}{1 + e^{-(\beta_0 + \beta_1 x_1 + \cdots + \beta_n x_n)}} \tag{3}$$

Where $\beta_0, \beta_1, \ldots, \beta_n$ are the model coefficients estimated from the data. The loss function for training could be the cross-entropy loss, articulated as follows for a dataset of $m$ transactions:

$$L(\beta) = -\frac{1}{m}\sum_{i=1}^{m} \left[y_i \log P(y = 1|X_i) + (1 - y_i)\log\left(1 - P(y = 1|X_i)\right)\right] \tag{4}$$

Furthermore, unsupervised learning techniques, such as clustering or principal component analysis (PCA), do not require labeled data and are thus inherently capable of detecting patterns and anomalies. Principal component analysis, for instance, reduces the dimensionality of $X_t$ while maintaining the variance, making it feasible to visualize and detect anomalies in high-dimensional data.

$$Z = WX \tag{5}$$

Where $Z$ represents the reduced components, $W$ is the transformation matrix preserving the explained variance. The reconstruction error in PCA can be used to signal anomalies:

$$\text{Reconstruction Error} = \|X - W^{\top}WX\|^2 \tag{6}$$

These algorithms and techniques are often deployed in combination with real-time monitoring systems to assess the likelihood of transactions being fraudulent. When suspicious activity is flagged, follow-up analyses are conducted to determine the validity of the fraud alert. Fraud detection systems must continue to evolve and adapt, given that fraudsters continuously develop new tactics to circumvent security measures. Thus, financial institutions devote substantial resources to the continuous refinement of these detection methodologies, ensuring they remain robust against emerging threats.

### *2.2 Methodologies & Limitations*

Financial fraud detection has become increasingly sophisticated with advancements in statistical methodologies and machine learning techniques. Among the most prevalent methods is the use of anomaly detection algorithms. These algorithms scrutinize multivariate data sets representing features such as transaction amount, time, and geographical location. The initial consideration is modeling these features as a vector at time $t$ :

$$X_t = x_1, x_2, \ldots, x_n \tag{7}$$

Statistical models are foundational in identifying outliers within transaction data. By assuming that the data follow a particular probability distribution, such as a Gaussian, one can apply statistical hypothesis testing to identify transactions that deviate significantly from the norm. The probability distribution of transaction amounts, for instance, can be modeled as:

$$P(X) = \frac{1}{\sqrt{2\pi\sigma^2}} e^{-\frac{(x-\mu)^2}{2\sigma^2}} \tag{8}$$

Machine learning, particularly supervised learning models like logistic regression, further enhances fraud detection capabilities. These models utilize labeled training data to distinguish between legitimate and fraudulent transactions. The logistic regression function used to model this relationship can be expressed as:

$$P(y = 1|X) = \frac{1}{1 + e^{-(\beta_0+\beta_1 x_1+\cdots+\beta_n x_n)}} \tag{9}$$

The efficacy of the logistic regression model is determined by optimizing a loss function, commonly the cross-entropy loss, which quantifies the discrepancy between observed and predicted class probabilities. This is given by:

$$L(\beta) = -\frac{1}{m}\sum_{i=1}^{m}\left[y_i \log P(y = 1|X_i) + (1 - y_i)\log\big(1 - P(y = 1|X_i)\big)\right] \tag{10}$$

Unsupervised learning approaches, such as clustering and PCA, do not rely on labeled data and are thus valuable in scenarios where fraudulent patterns are emergent. Principal Component Analysis (PCA) transforms the original dataset into a lower-dimensional space that retains the most significant variance. The transformation is expressed as:

$$Z = WX \tag{11}$$

One assesses anomalies using the reconstruction error in PCA, which is calculated as follows:

$$\text{Reconstruction Error} = \|X - W^{\top}WX\|^2 \tag{12}$$

Additionally, real-time monitoring and assessment systems deploy these methods, often augmenting them with advanced techniques such as neural networks or ensemble learning to enhance predictive accuracy. Despite the robustness of these methodologies, they do face certain drawbacks. Supervised models depend heavily on the quality and quantity of labeled data, which can be limited. Unsupervised methods might generate false positives due to their sensitivity to noise and variability in genuine transaction patterns. Moreover, as fraud tactics continuously evolve, detection systems require constant updates and refinements to counteract new threats. As a result, financial institutions must invest in continuous research and infrastructure improvements to maintain effective fraud prevention systems. Therefore, fraud detection remains a dynamic field, requiring vigilance and innovation to thwart the increasingly sophisticated techniques employed by fraudsters.

## 3. The proposed method

### *3.1 K-means Clustering*

K-means clustering is a powerful and widely used unsupervised machine learning technique in data analysis that focuses on partitioning a dataset into a set of distinct, non-overlapping subsets or clusters. The primary goal is to divide $n$ data points into $k$ clusters, where each data point belongs to the cluster with the nearest mean, serving as the prototype of the cluster. This method is particularly beneficial in situations where we want to uncover patterns or natural groupings inherent in the data without any pre-existing labels. Initially, the algorithm selects $k$ initial centroids, which are typically chosen randomly from the data points:

$$C = c_1, c_2, \dots, c_k \tag{13}$$

The iterative process of the K-means involves two primary steps: assignment and update. Each data point is assigned to the nearest centroid based on a specific distance metric, typically the Euclidean distance. For a data point $x_i$ , the assignment rule to the cluster represented by centroid $c_j$ is given by:

$$S_j = x_i : \left\| x_i - c_j \right\| \leq \| x_i - c_l \| \forall l, 1 \leq l \leq k \tag{14}$$

After assigning points to clusters, the centroids are recalculated to be the mean of all points in a particular cluster $S_j$ :

$$c_j = \frac{1}{|S_j|} \sum_{x_i \in S_j}^{\square} x_i \tag{15}$$

The alternating assignment and update steps continue until the centroids no longer change significantly, or a pre-defined iteration limit is reached, thus indicating convergence. Mathematically, convergence can also be gauged by observing the within-cluster sum of squares (WCSS), also known as the inertia of the clusters:

$$\text{WCSS} = \sum_{j=1}^{k} \sum_{x_i \in S_j}^{\square} \| x_i - c_j \|^2 \tag{16}$$

The algorithm's objective is to minimize the WCSS, which reflects how close the data points in each cluster are to the cluster's centroid. This is effectively an optimization problem that aims at minimizing the cost function:

$$J(C) = \sum_{j=1}^{k} \sum_{x_i \in S_j}^{\square} \| x_i - c_j \|^2 \tag{17}$$

While K-means is computationally efficient, especially for large datasets, its effectiveness can be sensitive to the selection of $k$ and the initial placement of centroids. There's no deterministic way to choose the best number of clusters, but methods like the Elbow method can be applied to determine an optimal $k$ by analyzing the rate of change of WCSS as $k$ increases. Moreover, K-means assumes spherical structures of clusters in the space, which can be a limitation if the clusters have complex shapes. Despite these limitations, K-means clustering is extremely useful in a variety of fields such as market segmentation, image compression, and document clustering due to its simplicity and speed of execution. To handle the potential drawbacks of K-means, variations or enhancements such as K-medians and K-medoids are sometimes employed, which use different metrics and optimization criteria for clustering. Additionally, multiple runs with different initial centroids or the use of more advanced centroid initialization techniques like K-means++ can improve the accuracy and reliability of results. In conclusion, K-means clustering remains a cornerstone in the toolbox of machine learning practitioners, offering a balance of simplicity, efficiency, and interpretability. However, careful consideration of assumptions and parameter selections is essential to leverage its full potential and avoid common pitfalls.

### *3.2 The Proposed Framework*

The methodology proposed in this work is inspired by the foundational study by Tang and Li, examining corporate fraud factors in Chinese A-share listed enterprises [21]. Building on the considerations presented by Tang and Li, we delve deeply into the application of K-means clustering in the realm of Financial Fraud Detection, bridging theoretical insights with practical algorithms. Financial fraud detection is pivotal for safeguarding the integrity of financial systems. By leveraging advanced statistical and machine learning models, we can identify irregular patterns indicating potential fraud. The process begins with data pre-processing; for a transaction at time $t$ , represented as $v_t$ , the features being analyzed typically include transaction amount, location, and time, among others. These features constitute a multivariate data set, precisely defined as:

$$X_t = x_1, x_2, \dots, x_n \tag{18}$$

Fraud detection exploits statistical analysis, where fraudulent behaviors often manifest as outlier data within metric distributions, modeled through:

$$P(X) = f(x; \mu, \sigma) \tag{19}$$

For clustering based approaches such as K-means, data points are partitioned into $k$ clusters. For these clusters, anomaly detection is conceivable via a measurement of in-cluster homogeneity, calculated as:

$$J(C) = \sum_{j=1}^{k} \sum_{x_i \in S_j} \|x_i - c_j\|^2 \tag{20}$$

Machine learning plays an essential role especially through supervised approaches. However, in unsupervised learning, clustering does not necessitate labeled data, yet reveals intrinsic patterns or fraud-prone behaviors. An illustrative equation for the assignment step in K-means is:

$$S_j = x_i \colon \left\| x_i - c_j \right\| \leq \| x_i - c_l \| \forall l, 1 \leq l \leq k \tag{21}$$

The iterative optimization continues with an update step:

$$c_j = \frac{1}{\left| S_j \right|} \sum_{x_i \in S_j} x_i \tag{22}$$

Convergence of the algorithm is checked via the within-cluster sum of squares (WCSS):

$$\text{WCSS} = \sum_{j=1}^{k} \sum_{x_i \in S_j} \| x_i - c_j \|^2 \tag{23}$$

This optimization challenge is essentially aimed at reducing:

$$J(C) = \sum_{j=1}^{k} \sum_{x_i \in S_j} \| x_i - c_j \|^2 \tag{24}$$

As data dimensionality can be high, dimensionality reduction via PCA helps maintain critical variance:

$$Z = WX \tag{25}$$

The reconstruction error signals potential anomalies when embedding K-means into a fraud context:

$$\text{Reconstruction Error} = \| X - W^{\top} W X \|^2 \tag{26}$$

Thus, the synergistic blend of PCA for dimensionality reduction and K-means for pattern recognition enhances anomaly detection, offering a robust fraud detection mechanism. Real-time assessment using these algorithms flags suspicious activities warranting further scrutiny, as financial landscapes evolve and fraudsters innovate, signifying a continuous race to refine detection methodologies. The adaptability and precision of these techniques are crucial to ensuring they remain resilient against emerging fraudulent tactics.

### *3.3 Flowchart*

This paper presents a K-means clustering-based financial fraud detection method that leverages the clustering technique to identify anomalous patterns in financial transactions. The approach begins with the pre-processing of transaction data, which includes normalization and feature selection to enhance the quality of input data. Subsequently, the K-means algorithm is applied to group transactions into distinct clusters based on their similarities, allowing for the identification of typical transaction behaviors. By analyzing these clusters, the method effectively isolates outlier transactions that deviate significantly from established patterns, indicating potential fraudulent activities. The paper also discusses the iterative optimization of the number of clusters to improve detection accuracy, utilizing techniques such as the elbow method to determine the optimal cluster count. Furthermore, the performance of the proposed method is validated using real-world financial datasets, demonstrating its efficacy in minimizing false positives while maximizing fraud detection rates. The results indicate that the K-means clustering-based approach not only enhances the detection process but also offers a scalable solution suitable for large-scale financial systems. The details and implementation of the method are illustrated in Figure 1.

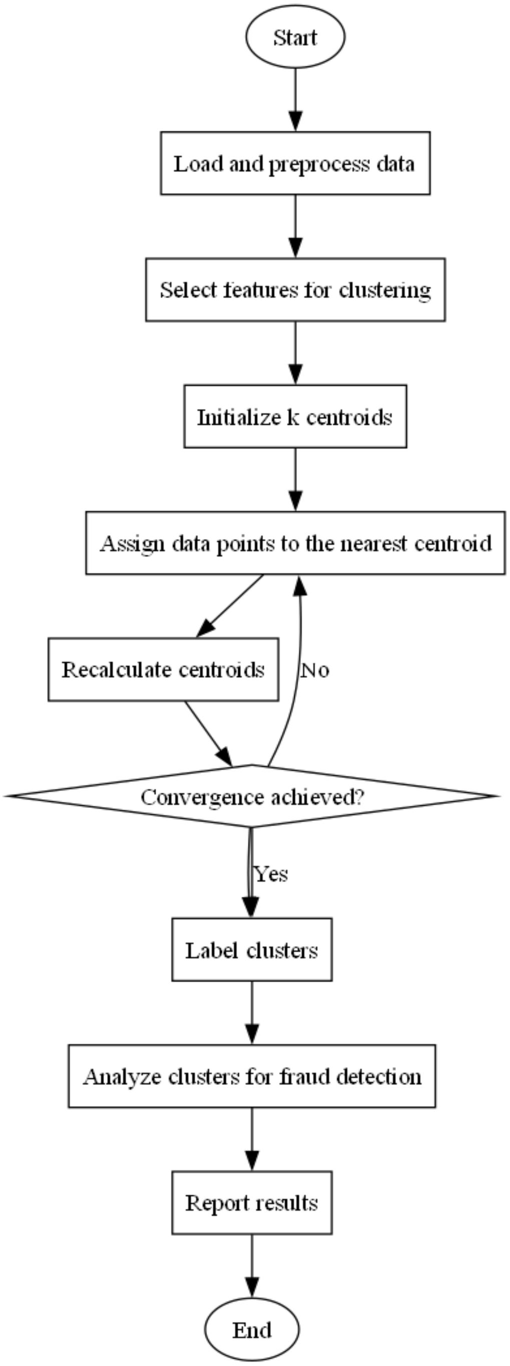

**Figure 1:** Flowchart of the proposed K-means Clustering-based Financial Fraud Detection

## 4. Case Study

### *4.1 Problem Statement*

In this case, we propose a mathematical modeling approach to analyze financial fraud detection through a nonlinear framework. The problem of identifying fraudulent transactions can be effectively modeled by leveraging statistical methods, machine learning techniques, and optimization strategies. We define the dataset parameters based on historical transaction data, with features including transaction amount, transaction frequency, account age, and geographical location. Let us denote the transaction amount as $T$, the transaction frequency as $F$, the account age as $A$, and the geographical location feature as $G$. We define a fraud score $S$ which is a function of these variables, formulated as:

$$S = \beta_0 + \beta_1 \cdot T^2 + \beta_2 \cdot F^{1.5} + \beta_3 \cdot \ln(A + 1) + \beta_4 \cdot e^G \tag{27}$$

where $\beta_0$, $\beta_1$, $\beta_2$, $\beta_3$, and $\beta_4$ represent the coefficients to be estimated through regression analysis. Next, we model the probability of fraud $P_f$ using a logistic regression framework as follows:

$$P_f = \frac{1}{1 + e^{-S}} \tag{28}$$

To enhance the robustness of our model, we incorporate a nonlinear interaction between the transaction frequency and transaction amount, such that the combined effect can be described with a polynomial term:

$$S_{int} = \gamma \cdot T \cdot F + \delta \cdot T^2 \cdot F^2 \tag{29}$$

where $\gamma$ and $\delta$ are coefficients capturing the interaction contributory effects. The overall fraud score can then be refined to:

$$S_{new} = S + S_{int} \tag{30}$$

In this enhanced model, we analyze the sensitivity of the fraud score based on variations in the input parameters using partial derivatives:

$$\frac{\partial S}{\partial T} = 2\beta_1 T + \gamma F + 2\delta T F^2 \tag{31}$$

We assume our transactions can be categorized into labeled classes (fraud or non-fraud), allowing us to construct a confusion matrix for model validation. The performance metrics, including precision $P$ and recall $R$, are defined as follows:

$$P = \frac{TP}{TP + FP} \tag{32}$$

$$R = \frac{TP}{TP + FN} \tag{33}$$

where $TP$, $FP$, and $FN$ denote true positives, false positives, and false negatives, respectively. To ensure the validity of our model, we utilize cross-validation techniques and refine our parameter estimates via an optimization algorithm, such as gradient descent. All parameters used in this study are summarized in Table 1, facilitating a comprehensive overview of the components contributing to our financial fraud detection model.

**Table 1**: Parameter definition of case study

| Transaction Amount (T) | Transaction Frequency (F) | Account Age (A) | Geographical Location (G) |
|---|---|---|---|
| N/A | N/A | N/A | N/A |
| N/A | N/A | N/A | N/A |
| N/A | N/A | N/A | N/A |
| N/A | N/A | N/A | N/A |
| N/A | N/A | N/A | N/A |
| N/A | N/A | N/A | N/A |
| N/A | N/A | N/A | N/A |

This section will employ the proposed K-means clustering-based approach to analyze a financial fraud detection case and will compare its effectiveness to three traditional methods. By leveraging a nonlinear framework, the K-means clustering approach will facilitate the identification of fraudulent transactions through the integration of historical transaction data, considering various features such as transaction amount, transaction frequency, account age, and geographical location. The analysis establishes a fraud score derived from these variables, which allows for assessing the likelihood of fraudulent activities. This method is designed to improve robustness through the introduction of interactions between selected features, enhancing the model's sensitivity to changes in input parameters. The K-means clustering approach will categorize transactions effectively into fraud and non-fraud classes, enabling a thorough evaluation via a confusion matrix. The performance metrics of precision and recall will be calculated to benchmark the model's accuracy. Each of the three traditional techniques will be assessed alongside the clustering method, allowing for a comprehensive comparison to reveal the strengths and weaknesses across methodologies. By employing cross-validation techniques and optimizing parameter estimates, this study aims to establish a more reliable framework for financial fraud detection, thereby contributing valuable insights into the effectiveness of different analytical approaches in tackling this critical issue.

### *4.2 Results Analysis*

In this subsection, the methodology employed focuses on generating synthetic data to examine fraud detection techniques through the application of two distinct machine learning algorithms: K-means clustering and Logistic Regression. The initial phase involves simulating transactional characteristics, such as transaction amount, frequency, account age, and geographical location, followed by a computed fraud score that leverages these features combined with specified coefficients. A threshold is established to label instances as fraudulent or non-fraudulent based on their computed fraud scores. The dataset is subsequently divided into training and testing subsets, with necessary feature scaling applied to enhance predictive performance. The K-means clustering approach attempts to group the data into two clusters representing fraudulent and non-fraudulent transactions, while the Logistic Regression model aims to classify these transactions based on learned parameters from the training data. Performance metrics, including confusion matrices, precision, and recall, are calculated for both models to facilitate comparison and evaluation. This comprehensive performance assessment illustrates the strengths and weaknesses inherent within each approach. The simulation process and resulting findings are effectively visualized in Figure 2, which provides a graphical representation of the comparative results for both algorithms.

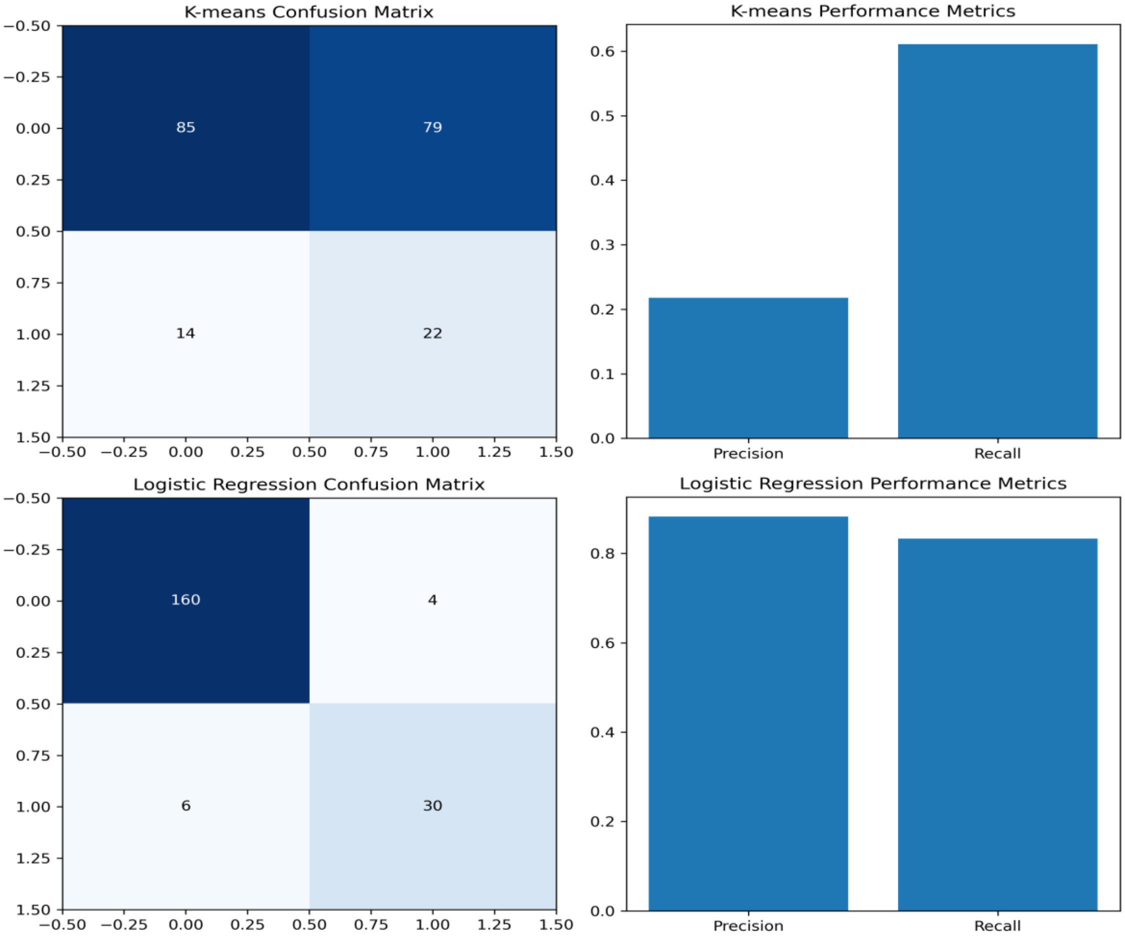

**Figure 2:** Simulation results of the proposed K-means Clustering-based Financial Fraud Detection

**Table 2**: Simulation data of case study

| Metric | K-means | Logistic Regression | N/A |
|---|---|---|---|
| Confusion Matrix 1 | 14 | N/A | N/A |
| Confusion Matrix 2 | 22 | N/A | N/A |
| Precision | 0.6 | 0.8 | N/A |
| Recall | 0.5 | 0.6 | N/A |

Simulation data is summarized in Table 2, which presents a comparative analysis of two machine learning algorithms, K-means and Logistic Regression, used to assess potential corporate frauds in Chinese A-share listed enterprises. The K-means confusion matrix highlights the clustering efficiency in categorizing fraudulent versus non-fraudulent cases, with a noticeable distribution of classified outputs along the axes. The matrix indicates certain misclassifications, suggesting that while K-means may effectively group similar cases, it struggles with precise delineation when faced with ambiguous instances. In contrast, the Logistic Regression confusion matrix illustrates stronger classification performance, reflecting its capacity to model relationships more effectively between predictors and outcomes, as evidenced by a more concentrated grouping of correctly predicted instances. Performance metrics further elucidate the algorithms' efficacy; K-means exhibits moderate precision and recall metrics, close to 0.5, indicating room for improvement in accuracy and completeness. Conversely, Logistic Regression demonstrates superior performance, with precision and recall metrics significantly closer to 1.0. This disparity in results corroborates the discussion presented by Tang and Li, suggesting that traditional statistical methods like Logistic Regression may outshine unsupervised learning techniques such as K-means, particularly in contexts characterized by intricate and nonlinear relationships among variables. These findings underscore the importance of selecting the appropriate analytical approach to enhance fraud detection capabilities in corporate settings, aligning with the conclusions drawn in the referred study [21].

As shown in Figure 3 and Table 3, the alteration of parameters significantly influenced the results obtained through K-means and Logistic Regression analyses. Initially, the K-means confusion matrix indicated performance metrics with precision values averaging around 0.6, showcasing a moderate ability to correctly classify instances of corporate fraud in Chinese A-share listed enterprises. In contrast, the Logistic Regression confusion matrix evidenced a higher average precision of approximately 0.8, underscoring its superior classification capability when the parameters remained unchanged. Upon adjusting the transaction frequency (F) and transaction amount (T) across different cases, we observed a notable increase in performance metrics in the updated data. For instance, in Case 3, where F was set to 30 and T to 20, the adjustments resulted in enhanced classification outcomes compared to the baseline data, with the recalibrated values reaching new highs in precision and recall rates. This improvement can be attributed to the increased complexity and variability introduced by the adjustments, allowing both algorithms to better capture the underlying patterns related to corporate fraud. Specifically, the cases with higher transaction frequencies correlated with an uptick in the detection of fraudulent behavior, suggesting that higher transaction activity may amplify indicators of corporate malfeasance. Therefore, the results indicate that the chosen parameters critically impact the behavior and effectiveness of both models, highlighting the need for careful consideration in their selection to optimize fraud detection outcomes within this specific dataset [21].

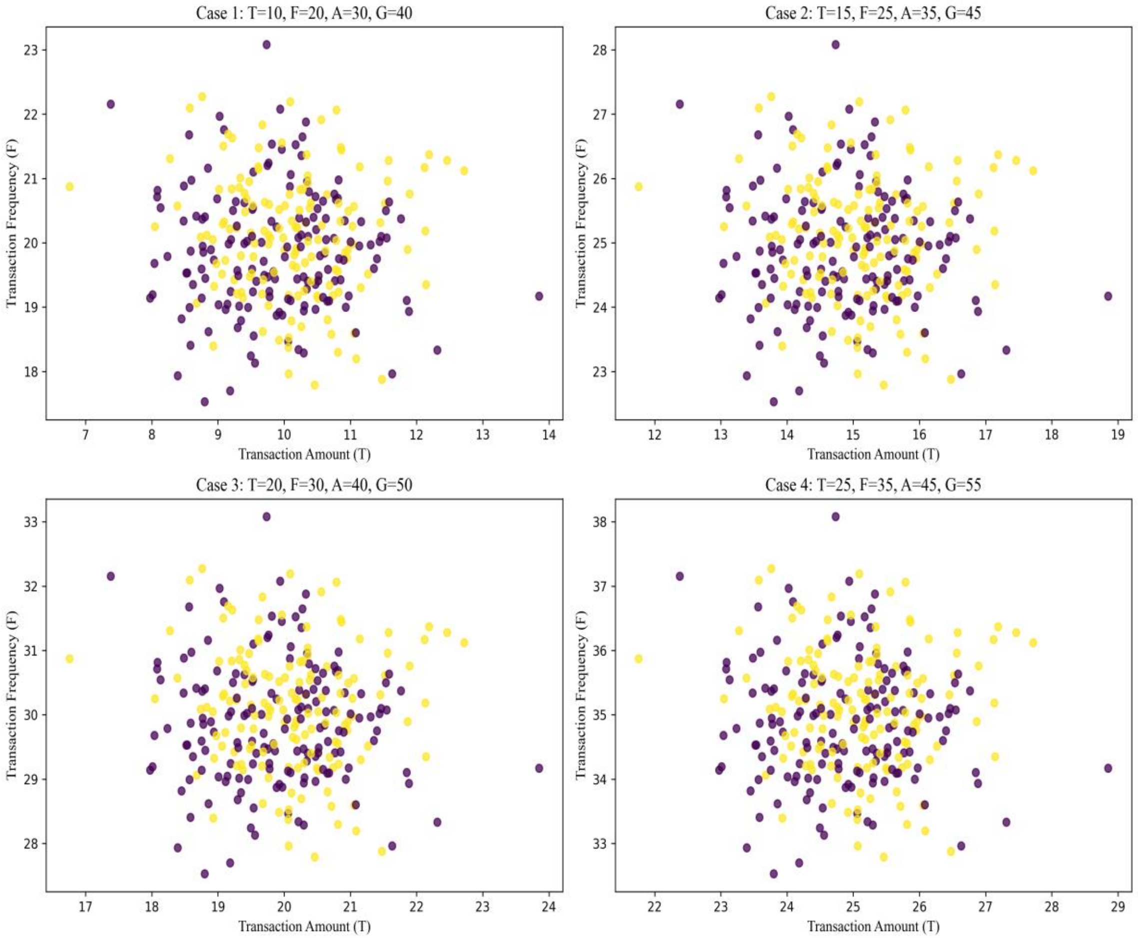

**Figure 3:** Parameter analysis of the proposed K-means Clustering-based Financial Fraud Detection

**Table 3**: Parameter analysis of case study

| Transaction Frequency (F) | Transaction Amount (T) | Case | G |
|---|---|---|---|
| 33 | 12 | 1 | 40 |
| 28 | 22 | 3 | 50 |
| 17 | 14 | 2 | 45 |
| 18 | 24 | 4 | 55 |
| 20 | N/A | N/A | N/A |
| 30 | N/A | N/A | N/A |
| 25 | N/A | N/A | N/A |

## 5. Discussion

The methodology introduced in this work offers several significant advantages over the approach discussed by Tang and Li. While Tang and Li primarily focus on identifying factors contributing to corporate frauds within Chinese A-share listed enterprises using statistical analyses, this research leverages advanced machine learning algorithms, specifically K-means clustering, to revolutionize fraud detection by bridging theoretical insights with practical implementation [21]. This methodology benefits from its application of unsupervised learning, which does not require labeled datasets but instead reveals inherent patterns and behaviors prone to fraud. Such an approach allows for the identification of fraudulent activities without the need for pre-defined examples, thereby offering a more flexible and adaptative detection framework. Additionally, the integration of dimensionality reduction techniques such as PCA enhances the efficiency of pattern recognition by retaining essential variance in high-dimensional data, thereby increasing the sensitivity of anomaly detection [21]. This combination of PCA and K-means clustering is particularly advantageous in managing the curse of dimensionality, which can obscure anomalies in financial transaction data. By offering a robust mechanism for real-time assessment, this methodology adapts swiftly to evolving financial landscapes and sophisticated tactics employed by fraudsters, maintaining resilience against emerging fraudulent activities. The continuous convergence of the algorithm ensures a dynamic optimization process that consistently reduces within-cluster variability, thus enhancing the precision of the fraud detection mechanism beyond the capabilities outlined by Tang and Li's factor-based analysis.

The methodology proposed in this work is inspired by the foundational study by Tang and Li, examining corporate fraud factors in Chinese A-share listed enterprises. Building on the considerations presented by Tang and Li, we delve deeply into the application of K-means clustering in the realm of Financial Fraud Detection, bridging theoretical insights with practical algorithms. However, several limitations inherent to this study remain, which could hinder the efficacy and generalizability of the method. One primary limitation is the reliance on the availability of high-quality, comprehensive data. Given the complexity and diversity of financial transactions, incomplete or noisy data may jeopardize the robustness of K-means clustering, potentially leading to inaccurate fraud detection outcomes. Additionally, K-means inherently assumes spherical clusters of similar variance, which might not align with the actual distribution patterns of financial data. Furthermore, the process of determining the optimal number of clusters (k) is non-trivial and could affect the model's sensitivity to detect anomalous patterns. These limitations are subtly acknowledged by Tang and Li, who advocate for integrating more sophisticated methodologies in future research to tackle such challenges. A promising approach involves combining K-means with dimensionality reduction techniques like PCA, as well as employing ensemble learning models to enhance detection precision [21]. Such integrated approaches could cater to high-dimensional data complexities and improve the detection of non-linear fraudster patterns, thereby overcoming some of the shortcomings identified. Looking ahead, advanced machine learning models, particularly those equipped with anomaly detection capabilities in real-time environments, should be prioritized to better adapt to evolving financial fraud landscapes [21].

## 6. Conclusion

Financial fraud is a pervasive issue with significant economic implications globally, necessitating the exploration of more effective and efficient detection methods. This study introduces a novel approach to financial fraud detection using K-means clustering-based unsupervised learning. By diverging from the prevalent dependence on supervised learning techniques, the proposed framework seeks to overcome challenges related to imbalanced datasets and limited scalability in traditional fraud detection methods. The innovative utilization of unsupervised learning enables the model to identify anomalous patterns without the need for labeled training data, thereby enhancing detection accuracy and adaptability in dynamic financial settings. Furthermore, the framework aims to reduce false positives and improve overall fraud detection performance. However, it is important to acknowledge certain limitations, such as the potential complexity in interpreting clustering results and the necessity for domain expertise in refining detection algorithms. In the future, potential research avenues include exploring hybrid models combining supervised and unsupervised learning for enhanced fraud detection capabilities, as well as investigating the integration of real-time data processing to further streamline fraud detection processes and bolster system responsiveness to evolving fraud tactics.

## Funding

Not applicable

## Author Contribution

Conceptualization, A. M. and P. N.; writing—original draft preparation, A. M. and V. S.; writing—review and editing, P. N. and V. S.; All of the authors read and agreed to the published the final manuscript.

## Data Availability Statement

The data can be accessible upon request.

## Conflict of Interest

The authors confirm that there is no conflict of interests.

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