

Chapter 4

INTERNAL CONTROLS

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Chapter 4

INTERNAL CONTROLS

Examination Objectives

- Determine whether the credit union has implemented efficient and effective operations and risk management systems
- Determine whether the credit union accurately records transactions
- Determine timeliness and reliability of financial reporting
- Determine whether the credit union complies with regulations, internal policies, and internal procedures
- Assess whether the credit union has implemented adequate internal controls to safeguard assets

Associated Risks

- Strategic risk occurs when management fails to (1) perform necessary due diligence as it applies to internal controls surrounding existing and proposed products and services, (2) act on recommendations included in examinations and internal/external audit reports, and (3) allocate the necessary resources to implement proper internal controls;
- Transaction risk occurs when internal controls do not sufficiently deter or detect errors, omissions, or material misstatements;
- Compliance risk occurs when the credit union fails to adhere to applicable laws and regulations; and
- Reputation risk occurs when management fails to meet its fiduciary duties, resulting in poor publicity or administrative action.

Overview

Internal control is defined as a process, developed by a credit union's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations;
- Reliability of financial reporting; and
- Compliance with applicable laws and regulations.

Internal control does not guarantee that the entity will achieve its objectives or even remain in business. Rather, internal control provides

management with reasonable assurance regarding the achievement of objectives. Inherent limitations to internal control exist and cost/benefit considerations will prevent implementation of all possible controls. Inherent limitations may also limit the effectiveness of internal controls.

§113 of the *FCU Act* states that the board of directors shall have the general direction and control of the affairs of the credit union, including the proper and profitable conduct of credit union operations, the safety of credit union assets, and the accuracy and adequacy of financial statements. The board retains overall responsibility for the affairs of the credit union. As part of that responsibility, the board establishes internal controls, which include organizational plans, policies, and operating procedures to maintain control over the duties delegated to paid employees.

Internal control systems assist management with the following:

- Measuring performance, making decisions, evaluating processes, and managing risks;
- Achieving its objectives and avoiding surprises; and
- Detecting mistakes caused by personal distraction, carelessness, fatigue, errors in judgment, or unclear instructions in addition to fraud or deliberate noncompliance with policies.

Effective and well-designed control systems are still subject to execution error. In other words, human beings still must execute most control systems and even well trained personnel with the best of intentions can become distracted, careless, tired or confused.

Consistent application and thorough understanding of internal control by credit union personnel can determine the effectiveness of board and management policies. Controls typically (1) limit authorities, (2) safeguard access to and use of records and credit union assets, (3) separate and rotate duties, and (4) ensure both regular and unscheduled reviews, including testing.

Safety and Soundness

The *FCU Act* and the bylaws establish the basic organizational pattern for credit unions. A credit union's growth necessitates further divisions

of duties and responsibilities. The following organizational procedures enhance the attainment of internal control:

- Approval of loan applications by a separate credit committee elected by the members or appointed by the board, or by a loan officer appointed by the credit committee or the board;
- The signing and countersigning of checks and notes by a person other than a disbursing officer;
- Approval of membership applications by the board, executive committee, or membership officer, rather than by the paid board officer, the financial officer, any assistant to the paid board officer or financial officer, or a loan officer;
- Internal audits by the supervisory committee or internal auditor conducted independently of any official or employee; and
- Maintenance of separate lists of accounts opened and closed for the information of the directors and supervisory committee by persons other than those handling the accounting records.

The bylaws and *Supervisory Committee Guide for Federal Credit Unions* contain other examples and information for achieving control through organization. (Appendix 4A, Conflicting Management Positions, addresses prohibited positions within the credit union and the officers or employees.)

Accurate Financial Statements

Essentially, the accounting system provides a credit union's management with the complete and accurate financial information needed to conduct sound and effective operations. Management uses financial statements produced by the system to report to the members, creditors, insurers, and NCUA. Adherence to generally accepted accounting principles and standards will assure compliance with the full and fair disclosure provisions of §702.402 of *NCUA Rules and Regulations*.

**Other Laws
and
Regulations**

Internal controls are checks and balances built into policies and procedures. The *FCU Act* requires several internal controls, while others develop out of daily experience.

Internal controls for credit unions prescribed by law, regulation, or sound business practices include providing a statement of account to each member, which shows the record of the member's transactions, and obtaining evidence from each borrower regarding receipt of loan funds.

The credit union's operating procedures should contain internal controls such as the following:

- Dividing duties so that no one person has sole control over any transaction and its recording;
- Establishing the flow of work so that one employee, acting independently, automatically verifies the work of another without necessarily duplicating any work already performed; and
- Providing physical and mechanical facilities that support the maximum level of accuracy and work output.

**Internal
Control
Components**

The formality of any control system will depend largely on a credit union's size, the sophistication of its operations, the number of employees, and its risk profile. Small credit unions can design less formal and less structured control systems that can achieve similar effectiveness as more formal and structured control systems at larger or more sophisticated credit unions. Effective control systems should have:

- A control environment;
- Risk assessment;
- Control activities;
- Accounting, information, and communication systems; and
- Self-assessment or monitoring.

Control Environment

The control environment reflects the commitment of the board and management to internal control. It provides discipline and structure to the control system. Elements of the control environment include:

- The organizational structure of the credit union. (Is the credit union's organization centralized or decentralized? Are authorities and responsibilities clear? Are reporting relationships well designed?);
- Management's philosophy and operating style. (Are the credit union's business strategies formal or informal? Is its philosophy and operating style conservative or aggressive? Have its risk strategies been successful?);
- Personnel's integrity, ethics, and competence;
- The external influences affecting the credit union's operations and risk management practices (e.g., independent audits);
- The attention and direction provided by the board of directors and its committees, especially the audit or risk management committees; and
- The effectiveness of human resources' policies and procedures.

Risk Assessment

Risk assessment is the identification, measurement, and analysis of risks - internal and external, controllable and uncontrollable, at individual business levels and for the credit union as a whole. Management must assess all risks in the credit union. Uncontrolled risk-taking can prevent the credit union from reaching its objectives and can jeopardize its operations. Effective risk assessment helps determine the risks, needed controls, and management of those controls.

Control Activities

Control activities are the policies, procedures, and practices established to help ensure that credit union personnel carry out board and management directives at every business level throughout the credit union. These activities help ensure that the board and

management act to control risks that could prevent a credit union from attaining its objectives. They should include:

- Reviews of operating performance and exception reports. For example, senior management should regularly review reports showing financial results to date versus budget amounts, and the loan department manager should review weekly reports on delinquencies or documentation exceptions;
- Approvals and authorization for accessing and performing transactions and activities, including wire transfers. For example, an appropriate level of management should approve and authorize all transactions over a specified limit, and authorization should require dual signatures;
- Segregation of duties to reduce a person's opportunity to commit and conceal fraud or errors. For example, custody of assets should not rest with the person who authorizes or records transactions;
- Dual control or joint custody over access to assets (e.g., cash, negotiable collateral, official checks, etc.);
- The requirement that officers and employees in sensitive positions take two consecutive weeks of out-of-office vacation each year, if practical;
- Design and use of documents and records to help ensure recording of transactions and events. For example, using pre-numbered documents facilitates monitoring;
- Safeguards for access to and use of assets and records. For example, to safeguard data processing areas, a credit union should secure facilities and control access to computer programs and data files; and
- Independent checks on completion of jobs and accuracy of recorded amounts. Examples of independent checks include account reconciliation, computer-programmed controls, management review of reports that summarize account balances, and user review of computer-generated reports.

Credit union directors must hold management and staff responsible for their actions. Credit unions must maintain written procedures or controls for certain areas, including, but not limited to, lending, investments, fraud prevention, the Bank Secrecy Act, privacy, and Truth in Savings. Although credit unions should have written internal control procedures in all areas, the mere existence of the procedures will not suffice. Personnel must understand control procedures and follow them conscientiously.

Control Systems

Accounting, information, and communication systems capture and distribute pertinent and timely information in a form that enables the board, management, and employees to carry out their responsibilities.

Accounting systems contain the methods and records that identify, assemble, classify, record, and report a credit union's transactions.

Information and communication systems assist staff in understanding (1) how they fit into the credit union's control system, (2) how their roles relate to those of others, and (3) how they must maintain their accountability. Information systems produce reports on operations, finance, and compliance that enable management and the board to run the credit union. Management must understand the information system's full capabilities (e.g., availability and content of reports.). Communication systems disburse information throughout the credit union as well as to members and regulators. (Appendix 4B contains a list of Information Systems Reports that examiners may find useful during an examination and when evaluating a credit union's internal controls.)

Self-Assessment or Monitoring

Self-assessment or monitoring is the credit union's own oversight of the control system's performance; employees within the area evaluate departmental or operational controls. Part of the normal course of daily operations and activities should involve ongoing monitoring. Internal and external audit functions, as part of the monitoring system, may provide independent assessments of the quality and effectiveness of a control system's design and performance.

All credit union personnel should share responsibility for self-assessment or monitoring. All employees should understand their responsibility to report breaches of the control system.

**Internal
Control
Evaluation**

Evaluating internal control involves:

- Identifying the internal control objectives relevant to the credit union;
- Reviewing pertinent policies, procedures, and documentation;
- Discussing controls with appropriate levels of personnel;
- Observing the control environment;
- Testing transactions as indicated by the level of risk;
- Sharing findings, concerns, and recommendations with the board of directors and senior management; and
- Determining that the credit union has promptly corrected noted deficiencies.

Examiners should base the scope, type, and depth of an internal control review on the credit union's size, complexity, scope of activities, and risk profile. Assessment of the credit union's audit function plays an important part in this determination. When management or examiners note internal control weaknesses, the credit union should take immediate action to correct the deficiencies.

**Strategic
Risk**

The strategies developed by management often determine effectiveness and efficiency of operations. Factors impacting the control environment include the integrity and ethical values of management, the competence of personnel, management philosophy and operating style, assignment of authority and responsibilities, and the guidance provided by the board. Examiners should also consider the following when assessing strategic risk:

- Involvement of board and management in the risk evaluation process. The board should perform due diligence on proposed, new and existing products and services and should evaluate internal or external resources used by management to ensure identification and monitoring of risk areas;

- The competency, knowledge level, and adequacy of resources of personnel involved in the risk assessment and evaluation processes;
- Whether the board and management discuss and appropriately evaluate risks and consider control issues during the planning stages for new products and activities;
- Whether audit personnel or other internal control experts participate when the credit union develops new products and activities;
- Whether the board and management consider and appropriately address technology issues; and
- The adequacy of the fidelity bond or other risk insurance coverage in relation to the requirements in *NCUA Rules and Regulations*.

**Transaction
Risk**

Policies and procedures set by the board and implemented by management should ensure the accuracy and integrity of data and information. Examiners should consider the following items when evaluating this type of risk:

- Whether current policies and procedures exist to ensure decisions made by officials, management and staff have appropriate approvals and authorizations for transactions and activities;
- Whether accounting controls exist to provide reasonable assurance that staff carries out transactions according to management's authorization, and records transactions to permit accurate and timely preparation of financial statements;
- Whether processes exist to ensure that:
 - Staff independently verifies the performance and integrity of each function (e.g., lending, wire transfers, etc.) using an appropriate sample of transactions;

- Staff reconciles accounts continually, independently, and in a timely manner and resolves and clears outstanding items, both on and off balance sheet;
- Staff keeps policy overrides to a minimum and reports exceptions to management;
- Management has limited the control for employees in sensitive positions or risk-taking activities (see the Control Activities section of this chapter.)

**Compliance
Risk**

Credit unions must comply with applicable laws and regulations. Examiners should assess the adequacy of information systems by determining:

- The type, number, and depth of reports generated for operational, financial, managerial, and compliance-related activities;
- Whether the credit union reviews the reports;
- Whether the credit union runs sufficient reports to properly run, monitor, and control the institution;
- Whether the credit union properly restricts access to information systems;
- Whether management performs the appropriate depth of due diligence and compliance review; and
- Whether management addresses compliance issues when considering new products and services.

**Reputation
Risk**

Reputation risk revolves around adequacy of information as it applies to credit union staff and management, members, and third parties (e.g., vendors, external auditors, etc.) To assess the adequacy of communication systems, examiners should consider the following:

- Reviewing procedures for imparting significant information throughout the credit union (from the top down and from the bottom up in the organizational chain), ensuring that personnel understand the following:
 - Their roles in the control system;
 - Their activities in relation to others; and
 - Their accountability for the activities they perform;
- Reviewing information disbursed to external parties for compliance with fair credit and privacy regulations prior to its release;
- Assessing the frequency and thoroughness of verification of accounting, information, and communication systems by considering the following:
 - Frequency of testing given the level of risk and sophistication of the systems;
 - Sufficiency of ongoing reviews of the systems' accuracy;
 - Competency, knowledge, and independence of the personnel doing the testing;
- Determining oversight by senior management and the board over internal controls, control reviews, and audit findings. The board or a designated board committee should review management's actions to address material control weaknesses and verify the objectivity and adequacy of corrective actions. Examiner's should review the following:
 - Minutes of appropriate board and committee meetings, and
 - Audits or other control review reports and follow-up reports;
- Reviewing the frequency and comprehensiveness of reports to the board or board committee and senior management. Sufficient detail and timely presentation will allow for resolution and appropriate action;
- Assessing the oversight by the board or supervisory committee of audit and other control functions. The board or supervisory

committee should review the qualifications and independence of personnel evaluating controls (e.g., external auditors, internal auditors, or line managers);

- Evaluating the adequacy and independence of the audit or other control review function by considering the following:
 - Organizational structure and reporting lines;
 - Scope and frequency of audits or reviews;
 - Results of audit or other control review evaluations and supporting work papers;
 - Audit or control review reports, management responses, and follow-up reports; and
 - Appropriate and prompt attention directed in areas with identified control weaknesses; and
- Reviewing management's responses, documentation, and tracking of findings to enact adequate follow-up. Credit unions should establish a system of accountability to ensure satisfactory and effective follow up on control weaknesses.

**Workpapers
and
References**

- Workpapers
 - Management Review Questionnaires
 - Loan Internal Control Questionnaires
 - Loans-Lines of Credit/Credit Cards
 - Collection Program
 - Investment Internal Control Questionnaires
 - Cash Control Questionnaire
 - Information Systems Review
 - Red Flags
 - Red Flag Procedures
- References
 - *Federal Credit Union Act §113*
 - *NCUA Rules and Regulations §702.402*
 - *Supervisory Committee Guide for Federal Credit Unions*
 - *Accounting Manual for Federal Credit Unions*
 - Generally Accepted Accounting Principles
 - *Federal Credit Union Handbook*

CONFLICTING MANAGEMENT POSITIONS - APPENDIX 4A

Conflicting Positions

Positions In Federal Credit Unions and Persons Who are Prohibited From Holding Them

Position	Prohibited by Law, Regulation, or Bylaw	Prohibited by Principles of Sound Internal Control
Chief Executive Officer (CEO)	Vice President Secretary Assistant Secretary Treasurer Assistant Treasurer Manager Assistant Manager Membership Officer (if the President countersigns checks)	Member of the supervisory committee Supervisory committee assistant Credit union employee
Assistant Executive Officer	President Secretary Assistant Secretary Treasurer Assistant Treasurer Manager Assistant Manager Membership Officer (if the Vice-President countersigns checks)	Member of the supervisory committee Supervisory committee assistant Credit union employee
Recording Officer (Secretary)	President Vice President Manager Assistant Manager	Member of the supervisory committee Supervisory committee assistant Credit union employee
Assistant Secretary	President Vice President Treasurer	
Financial Officer (Treasurer)	President Vice President Member of the supervisory committee Supervisory committee assistant Membership Officer Assistant Secretary	Member of Credit Committee
Assistant Treasurer	President Vice President Membership Officer	Member of the supervisory committee Supervisory committee assistant
Director	Manager Assistant Manager (Only one director may also be a member of the supervisory committee)	Credit union employee

EXAMINER'S GUIDE

Position	Prohibited by Law, Regulation, or Bylaw	Prohibited by Principles of Sound Internal Control
Executive Committee Member	Any officer or employee other than a director (Only directors may serve as Executive Committee members)	Member of the supervisory committee Member of the credit committee Credit union employee Membership Officer
Supervisory Committee Member	Member of the credit committee Credit union employee Treasurer (Only one board member may also serve on this committee.)	Loan Officer Membership Officer Assistant Treasurer President Vice-President Secretary
Credit Committee Member	Member of the supervisory committee Supervisory committee assistant (Only one credit committee member may also be appointed a loan officer.)	Treasurer Manager
Loan Officer	Membership Officer (Only one credit committee member may be appointed a loan officer.)	Member of the supervisory committee Supervisory committee assistant
Membership Officer	Treasurer Assistant Treasurer Loan Officer Manager Assistant Manager President or Vice-President if checks are countersigned	Member of the supervisory committee Supervisory committee assistant
Manager	Member of the board of directors except by bylaw provision President Vice-President Member of the supervisory committee Supervisory Committee Assistant Membership Officer	Relative of any official Member of the credit committee
Assistant Manager	Member of the board of directors Member of the supervisory committee Supervisory Committee Assistant Membership Officer	Relative of any official

CONFLICTING MANAGEMENT POSITIONS - APPENDIX 4A

Position	Prohibited by Law, Regulation, or Bylaw	Prohibited by Principles of Sound Internal Control
Supervisory Committee Assistant	Treasurer Assistant Treasurer Manager Assistant Manager Member of the credit committee Credit union employee	Loan Officer Membership Officer Relative of any official or employee Assistant Treasurer President Vice-President Secretary
Credit Union Employee	Member of the supervisory committee Supervisory Committee Assistant	Relative of any official Member of the board of directors

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INFORMATION SYSTEM (IS) REPORTS – APPENDIX 4B

Examiners may use the following loan, share, and other reports frequently generated by the credit unions' information system (IS) to assist in the review of internal controls whether the credit union provides a download or generates the reports in-house. Good internal controls also require regular review of these reports by credit union management and the internal audit staff.

File Maintenance report - Identifies all changes made through the computer system that affect members' accounts. Also called the Non Financial Transaction report, this report usually differentiates between old and new data so the user can determine the credit union's changes. Changes that occur most often include: addresses, telephone numbers, loan due dates, payment amounts, interest rates, and maturity dates. Examiners may review a sample of these changes to determine that management properly authorized the changes and staff properly documented them.

Paid Ahead Loans report - Identifies loans with advanced due dates. When reviewing this report, the examiner should compare the borrower's actual payments over time to the note's required payment schedule. If discrepancies exist, the examiner should review a sample of related loan files, being especially cognizant of paid ahead loans where staff performs frequent file maintenance changes or where the prior activity date is long past (may be a deficiency balance that the credit union failed to charge off). Since a payment is due every month on open-end loans, they should not appear on the paid ahead report. Most IS reports flag open end loans so they do not appear on this report; however, the credit union may not have implemented this feature.

Accrued Interest Greater than Scheduled Payment report - Often reveals large portions of accrued interest that the credit union has not collected on specific accounts. In most cases, the majority of borrowers on this report are also delinquent or the note is a single payment note. If delinquency is not an issue, the examiner should determine why the account is on this report.

No Payments in the Last 90 Days report - Accounts listed are typically delinquent or single payment notes. This report can help the examiner pinpoint collection department problems. Examiners should inquire as to discrepancies between this report and the paid ahead report, and should review file maintenance changes made to these accounts.

Interest Rates < 5% or > 18% report - Examiners should review loan rates that fall into these categories and determine their accuracy. Interest rates greater than 18% are in error or illegal. Likewise, examiners should determine reasons for rates less than 5% (loans with no or special interest rates could be work-out loans).

Supervisory Override report - Documents system overrides by personnel who have the authority to make the specified changes. Credit unions should establish parameters that limit employees' access to the overall IS (proper segregation of duties). Because of staff limitations in small credit unions, one person may have the authority to make all changes, making the review of internal controls more critical.

First Payment Date >45 days from Original Loan Date report - Determines if the credit union has advanced due dates of any closed-end loans. In cases where the IS calculates delinquency from the first payment date rather than from the next due date, the IS must change the first payment when it advances the due date. The credit union should review the files of the loans appearing on the report to determine that the credit union appropriately approved an extension.

Loan Accounts with a PO Box report - Reveals different loan accounts with the same post office box, which could disclose fictitious loans.

Non-Amortizing Loans report - Reveals those loans with no principal reduction over time. Single payment or student loans may appear on this report. Examiners should review loans on the report and determine if and why the IS advances due dates.

Cash Transactions over \$10,000 report - Identifies cash transactions that the credit union must report on the Currency Transaction report

and file with the Treasury Department. The review of this report may reveal fictitious deposits.

Cash Payment Loans report - Reveals those loan accounts where the credit union applied cash payments rather than payroll deduction payments to the remaining principal. Examiners may find this report useful if they suspect fictitious loan activity.

Negative Share and Share Draft report - Identifies accounts with negative balances as of the report date (usually printed as of month end); however, examiners may ask the credit union to print the report while they are on-site to determine if the credit union is hiding overdrafts. Reviewing a sample of related accounts may allow examiners to ascertain the reasons for and the duration of the negative accounts.

Shares > \$100,000 report - May identify the credit union's share mix, share concentrations, uninsured shares, and possibly illegal deposits.

Share Accounts with a PO Box report - Reveals if different accounts have the same post office box. The credit union (or examiners at the examination) should trace a sample of accounts to membership cards and review them for validity. If the credit union provides a download of share accounts, the examiner can apply various sort commands to the accounts on the report.

NSF's YTD report - Tracks those members with the most non-sufficient funds (NSFs) for the year. The credit union (or examiners) should compare the report to the credit union's share draft policies to review for NSF abuse. Most IS can generate this report.

Dormant Share Accounts report - Identifies accounts with no activity for the past year (or another given time frame.) Examiners should determine that the credit union is in compliance with the state's abandoned property laws.

Insiders' report - Identifies the accounts of officials and often includes accounts of key management and family members of officials and key management.