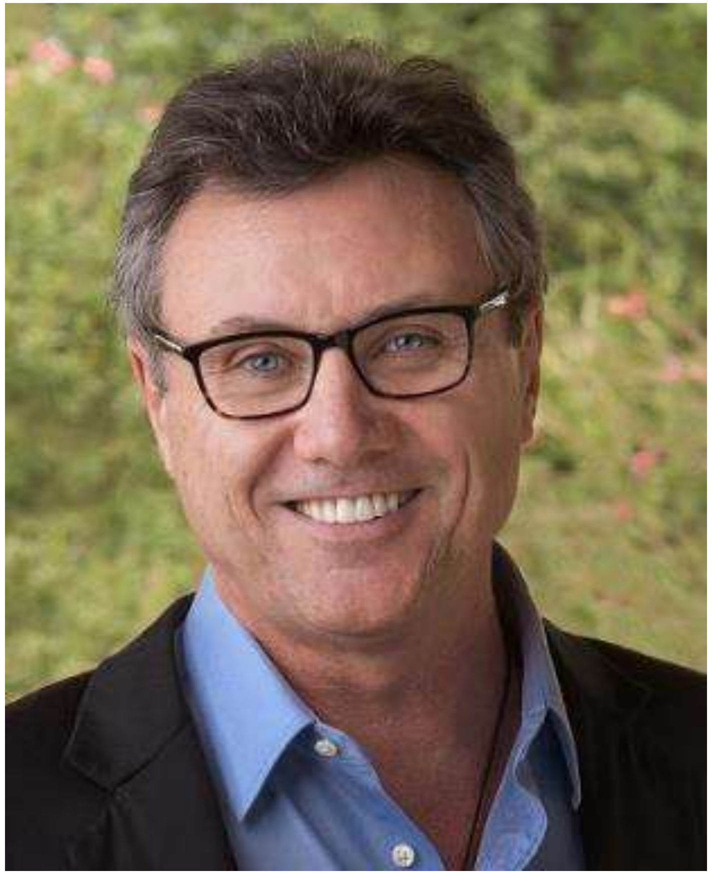
NACUSAC

NATIONAL ASSOCIATION OF CREDIT UNION SUPERVISORY & AUDITING COMMITTEES

Training Seminar for Credit Union Supervisory & Audit Committee Members - 2026



Timothy Harrington, CPA ret

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TEAMResources

Presented by Timothy Harrington

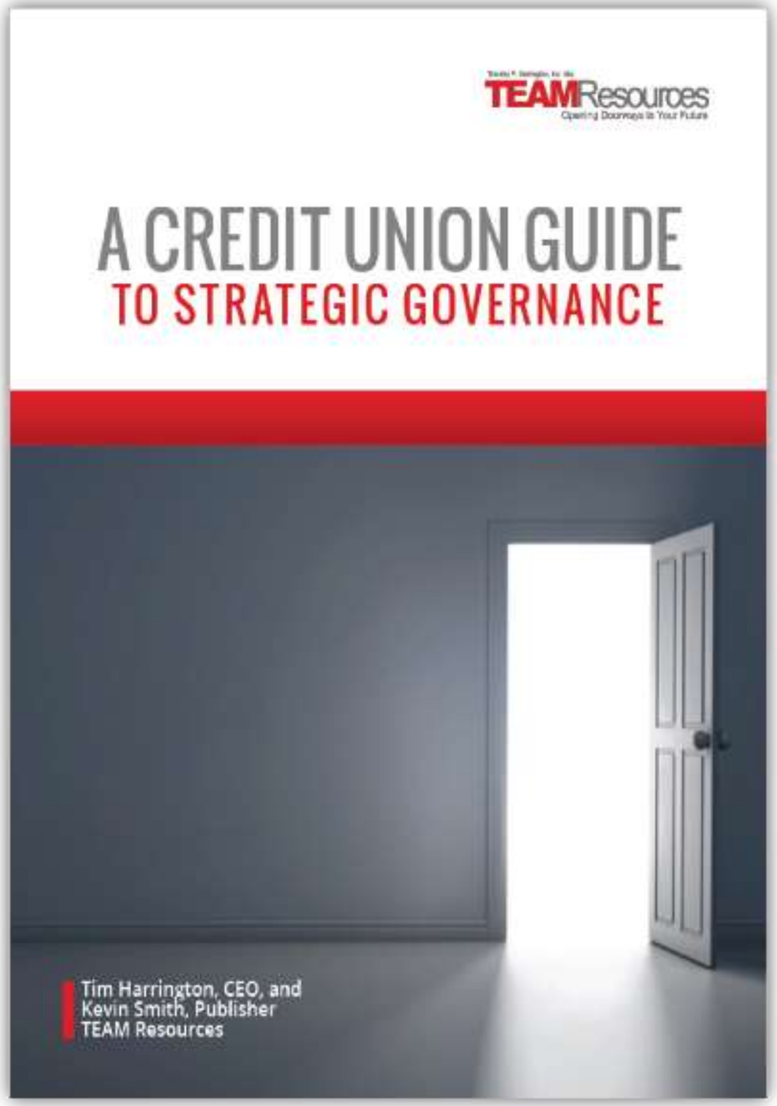
Tim Harrington is a Certified Public Accountant who has consulted with financial institutions since 1992. Since 1996, Tim has been President of TEAM Resources, a firm that provides consulting, strategic planning and training to financial institutions from coast-to-coast. He is the author of the popular the books

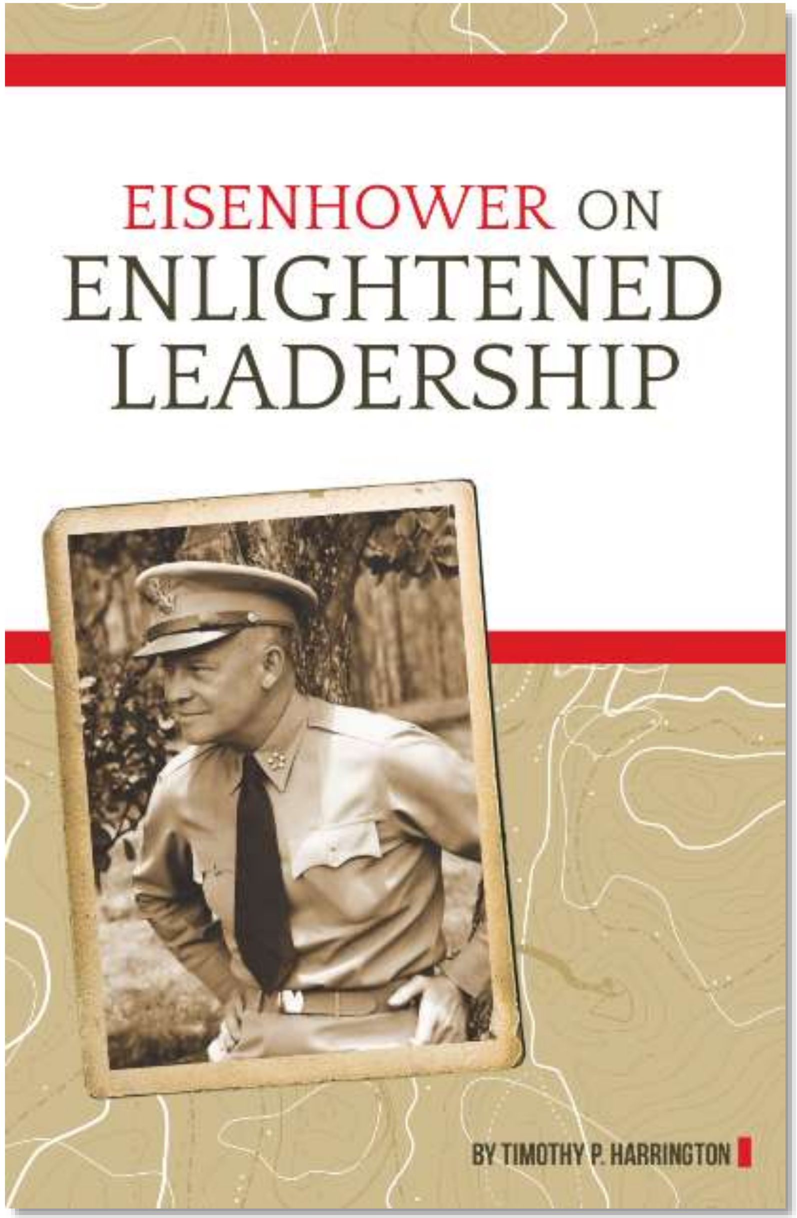
Eisenhower on Enlightened Leadership and

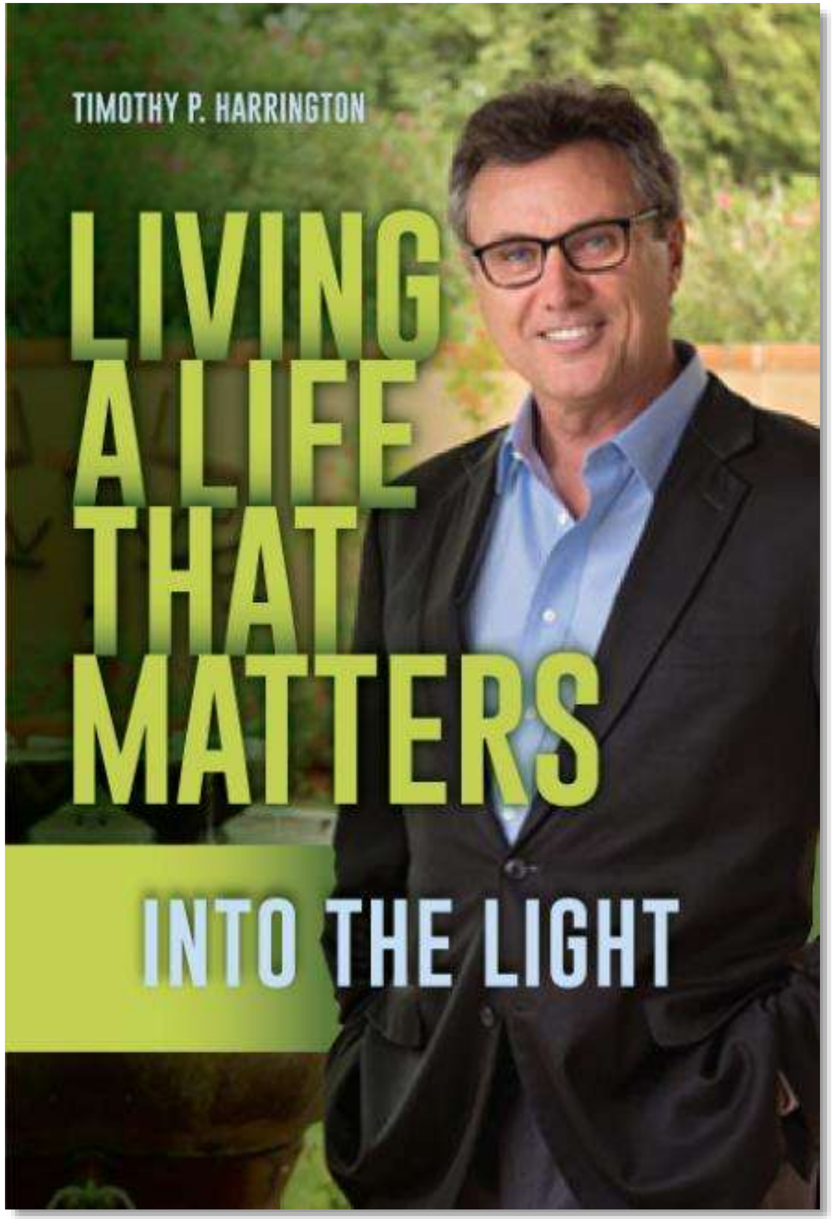
Living a Life that Matters and co-author of

A Credit Union Guide to Strategic Governance.

Tim is a faculty member of two national credit union schools on governance and management, and has spoken to hundreds of thousands of directors, executive management and staff throughout the Northern Hemisphere.


TEAMResources
A CREDIT UNION GUIDE
TO STRATEGIC GOVERNANCE
Tim Harrington, CEO, and
Kevin Smith, Publisher
TEAM Resources


EISENHOWER ON
ENLIGHTENED
LEADERSHIP
BY TIMOTHY P. HARRINGTON


TIMOTHY P. HARRINGTON
LIVING
A LIFE
THAT
MATTERS
INTO THE LIGHT

Observe and Report

The Supervisory Committee is **NOT** a training ground for the board

It has its own, critical role in ensuring internal controls and reliable financial reporting

Observe and Report

*You Are the **Cornerstone** of*
***Internal Controls** for the*
people who have
entrusted this job to you…

The Credit Union Members

You Are Part of the Corporate Governance Team

One Team
Three Parts

CEO

Leadership and Operations

Board of Directors

Vision and Accountability

Supervisory Committee

Annual Audit and Internal Controls

Carry out day to day operations of the business

Provide day to day and visionary leadership

Communicate to Board

No Surprises

Represent the member/owners

Hire and support a competent CEO

Hold CEO accountable to expectations

Ensure efficient use of resources

Communicate to member/owners

No Surprises

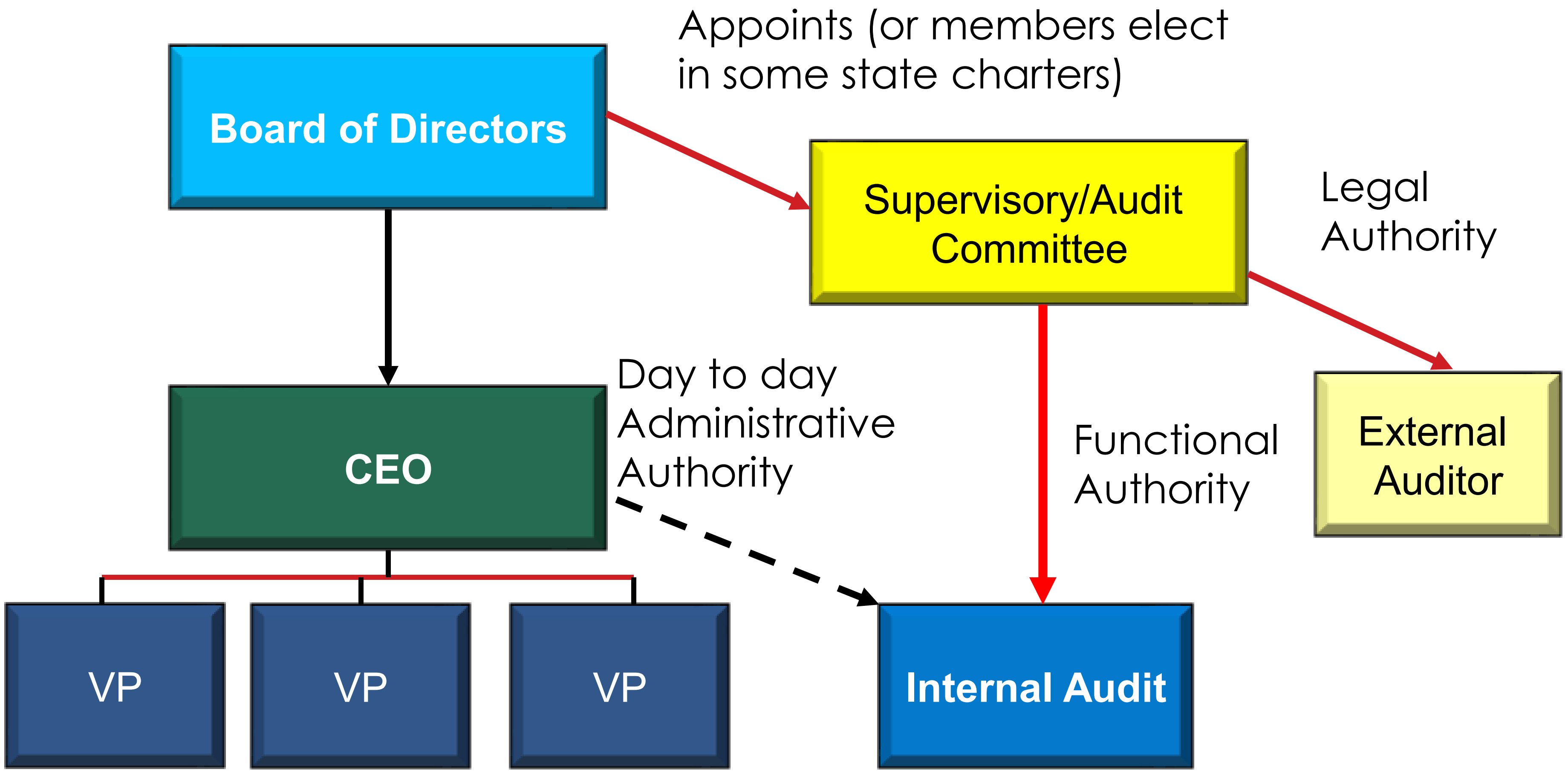
Trust the other two but verify

Ensure financial statements are ‘**reasonable**’ (audit)

Determine if **Internal controls** are adequate (audit)

Hire and cultivate a relationship with a competent outside **audit firm**

Best Practice Structure per Institute of Internal Auditors



Internal Audit Best Practices

Functional authority includes:

- **Internal Audit Charter Approval:** The SC establishes and formally approves the Internal audit charter, which defines the function's purpose, scope, and authority.
- **CAE Oversight:** The SC is responsible for the appointment, performance evaluation, compensation, and (if necessary) dismissal of the Chief Audit Executive (CAE) and IA staff
  - This should be done in cooperation of management and with the help of the HR department. They likely have more experience than you in hiring/firing and even determining if someone is qualified. But you need “final” say on these issues.
- **Audit Plan and Budget:** The SC reviews and approves the annual internal audit risk assessment, audit plan, and budget.
- **Unrestricted Access:** The Board, via the charter, authorizes internal audit to have full and unrestricted access to all records, personnel, and physical properties needed to carry out its duties.
- **Direct Communication:** The CAE has a direct reporting line to the Board and typically meets in executive sessions with the SC to discuss sensitive matters without management present.
- **Evaluation:** Both the SC and management should be involved in the evaluation process. The SC evaluates on what it deems important.

Internal Audit Best Practices

Administrative authority includes:

- **Financial Management:** Administration of the internal audit budget and management accounting.
- **Human Resources:** Management of day-to-day HR matters such as attendance, leave approvals, and payroll for audit staff.
- **Operational Support:** Provision of physical office space, equipment, and technology (e.g., audit software).
- **Internal Communication:** Facilitation of information flows and adherence to the organization’s internal policies and procedures, such as expense report approvals.
- **Organizational Integration:** Ensuring the internal audit function is appropriately interfaced with other business units to support effectiveness.

Working with Internal Audit

Best practices indicate

- Internal Audit works best:
  - When its **independence is protected** by the Audit Committee
  - When it is considered a **part of Management** and is supervised on a routine basis by Management
  - When it **reports dually** to the Audit Committee and Management
  - When **hiring is done dually** with the Audit Committee and Management
  - When it can only be **terminated** by the Audit Committee

Some of the Basic Rules

Who Regulates Us?

- National Credit Union Administration (NCUA)
  - Federally chartered (FICUs)
  - Federally Insured state chartered CUs (FISCUs)
  - Administers NCUSIF (National Credit Union Share Insurance Fund)
- State financial institution departments
  - For state chartered credit unions
- Consumer Financial Protection Bureau (CFPB)
  - All financial services providers

Desirable Characteristics of Committee Members

- Willingness to take time to do what is necessary to carry out the committee's tasks
- Ability and willingness to ask probing questions about business risks and financial matters
- Willingness to learn
- Independence in attitude
- Independence in fact
- Expertise in financial accounting and reporting
- Credit union or other financial institution experience

Reg. 715: General Responsibilities of the Supervisory Committee

(a) Basic. The supervisory committee is responsible for ensuring that the board of directors and management of the credit union:

- Meet required financial reporting objectives;
- And **establish** practices and procedures sufficient to safeguard members' assets.

Reg. 715: General Responsibilities of the Supervisory Committee

(b) Specific. To carry out the responsibilities set forth in paragraph (a) of this section, the supervisory committee must determine whether:

- **Internal controls** are established and effectively maintained to achieve the credit union's financial reporting objectives which must be sufficient to satisfy the requirements of the supervisory committee audit, verification of members' accounts and its additional responsibilities;
- The credit union's accounting records and financial reports are **promptly prepared and accurately reflect** operations and results;
- The **relevant plans, policies, and control procedures** established by the board of directors **are properly administered**; and
- Policies and control procedures are **sufficient to safeguard** against error, conflict of interest, self-dealing and fraud.

Reg. 715: General Responsibilities of the Supervisory Committee

(c) Mandates. In carrying out the responsibilities set forth in paragraphs (a) and (b) of this section, the Supervisory Committee must:

- Ensure that the credit union adheres to the **measurement** and **filing requirements** for reports filed with the NCUA Board under § 741.6 of this chapter; (5300 Call Report)
- Perform or obtain a **supervisory committee audit**, as prescribed in § 715.4 of this part;
- Verify or cause the **verification of members' passbooks** and accounts against the records of the credit union, as prescribed in § 715.8 of this part;
- Act to **avoid imposition of sanctions** for failure to comply with the requirements of this part, as prescribed in § 715.11 and § 715.12 of this part.

Supervisory Committee

Federal CU Standard Bylaws Article 9

Section 1. The supervisory committee:

- is appointed by the board from among the members of this credit union
  - one of whom may be a director other than the financial officer.
- The board determines the number of members on the committee,
- Which may not be fewer than 3 nor more than 5.
- No member of the:
  - credit committee (if applicable)
  - or any employee of this credit union

  may be appointed to the committee.

It's best to have a number of odd members….Or is it an odd number of members?

Supervisory Committee
Federal CU Standard Bylaws Article 9

Section 2. *Officers of supervisory committee*.

The supervisory committee members choose from among their number a chair and a secretary. The secretary of the supervisory committee prepares, maintains, and has custody of full and correct records of all actions taken by it. The offices of chair and secretary may be held by the same person.

Supervisory Committee

Federal Credit Union Act 1761 (d)

The supervisory committee shall:

- make or cause to be made an annual audit
- and shall submit a report of that audit to the board of directors
- and a summary of the report to the members at the next annual meeting of the credit union

Shall make or cause to be made:

- such supplementary audits as it deems necessary or as may be ordered by the Board,
- and submit reports of the supplementary audits to the board of directors

Duties of the Supervisory Committee – States. It Varies

- CU may have a Supervisory Committee – Depends on state,
- Some states call it an Audit Committee
- Some states have both
- and some don't require this committee.
  - I RECOMMEND IT NO MATTER WHAT!

- Members may be elected or appointed (depends on state law)

- Sometimes, 1 member may be a director who is not an officer of the board

- By a unanimous vote, committee may suspend a member of the credit union board for cause
  - Your bylaws or state law guide the process

Legal Qualifications for Supervisory Committee Membership - *Fed Charters*

- Must be a member of the credit union
- Must be bondable
- May be a board member - but not the financial officer
- Cannot be:
  - Credit Committee member
  - Employee of the credit union

Desirable Characteristics of Committee Members

- Willingness to take time to do what is necessary to carry out the committee's tasks
- Ability and willingness to ask probing questions about business risks and financial matters
- Willingness to learn
- Independence in attitude
- Independence in fact
- Expertise in financial accounting and reporting
- Credit union or other financial institution experience

Recommendations for the Supervisory Committee

- **Manage the outside audit function**
- Meet at least quarterly
- Keep fully informed as to the financial condition of the credit union and the decisions of the credit union's board
- Report its findings and recommendations to the board and make an annual report to members at each annual membership meeting

Observe and Report

Recommendations for the Supervisory Committee

Submit Monthly Reports to be included in the Board Packet

- Submit a report of your activities and findings
- Ensure that the report is part of the Board Packet
  - This way it becomes a part of the Corporate Record
- If you have issues or concerns that the report should be aware of, include them in the monthly report

Observe and Report

And in Awful Circumstances…

Causes for Suspension

Violations of:

- FCU Act
- Rules and Regulations
- Charter
- By-laws
- Unsafe acts

Supervisory Committee

Federal CU By-laws-Article 9

Section 6. By the affirmative vote of a majority of its members, the supervisory committee may call a special meeting of the members to consider any violation of the provisions of the Act, the regulations, or of the charter or the bylaws of this credit union, or to consider any practice of this credit union which the committee deems to be unsafe or unauthorized.

And in Awful Circumstances…

The Hammer – Bylaws Article 9

Section 6.

By unanimous vote, the supervisory committee may suspend until the next meeting of the members any director, board officer, or member of the credit committee. **In the event of any such suspension, the supervisory committee** must call a special meeting of the members to act on the suspension, which meeting must be held not fewer than 7 nor more than 14 days **after the suspension. The chair of the committee acts as chair of the meeting unless the members select another person to act as chair.**

Rights of Suspended People

A special meeting of the members to act on the suspension

- The special meeting must be held within seven to fourteen days after the suspension

The person being suspended must be given an opportunity to present a defense and be given due process

Supervisory Committee

Federal Credit Union Act 12 U.S.C. 1763

- Any member of the supervisory committee may be suspended by a majority vote of the board of directors.
- The members shall decide, at a meeting held not less than seven nor more than fourteen days after any such suspension, whether the suspended committee member shall be removed from or restored to the supervisory committee.

Selecting the Outside Auditor

Emerging Supervisory Committee Role

The Audit Committee

- Develops an Annual Plan
- Prepares a Request for Proposal (**RFP**) perhaps tri-annually
- Compares the responses to the RFPs and interviews the audit firms to find the right fit
- **Interviews** the audit firm after the audit (executive session)
- Attends regulator’s **exit conference**
- **Interviews** key management personnel after the audit
- Ensures findings are **resolved** by management
- **Evaluates** the audit firm
- **Evaluates** the board and management…kind of
- Evaluates itself

Who Hires the Outside Auditor?

For Federal charters, the law is clear. The Supervisory Committee hires the Outside Auditor. Reg. *715.9(b)*

"In all cases, the engagement must be contracted directly with the Supervisory Committee. The engagement letter must be signed by the compensated auditor and acknowledged therein by the Supervisory Committee prior to commencement of the engagement."

For state charters, it depends on state statutes.

Audit Requirements
NCUA Rules and Regulations
Federally Chartered Credit Unions

$500 Million or More	Financial statement audit per GAAS by independent, State-licensed person
$10 Million - $500 Million	Either: -financial statement audit -or Other Supervisory Committee Audit per Other Supervisory Committee Audit Minimum Procedures Guide
Under $10 Million	Other Supervisory Committee Audit

Audit Requirements
NCUA Rules and Regulations
State Chartered Credit Unions

$500 Million or More	**Financial statement audit** per **GAAS** by **independent, State-licensed person**
Under $500 Million	Either: -financial statement audit -or Other Supervisory Committee Audit per Other Supervisory Committee Audit Minimum Procedures Guide

Translation?

- Financial statement audit = Certified or Opinion audit
- per GAAS = Generally Accepted Auditing Standards. Steps required for it to be a certified audit
- by independent, State-licensed person = CPA

Who does the Audit?

- **Must be someone independent of the management and board**
- If a Certified Audit (Financial Statement Audit), must be performed by a CPA
- Otherwise, any independent party can perform audit

§715.9 (a) Assistance from outside, compensated person

Unrelated to officials. A compensated auditor who performs a Supervisory Committee audit on behalf of a credit union shall not be related by blood or marriage to any management employee, member of either the board of directors, the Supervisory Committee or the credit committee, or loan officer of that credit union.

What is a Certified or Opinion Audit?

It is an audit conducted in accordance with US generally accepted auditing standards (GAAS)

Those standards require planning and performing audit to provide reasonable assurance statements are free of material misstatement

Will state in opinion letter whether financial statements present fairly the financial condition

Pros: Extensive and you receive 'certification'

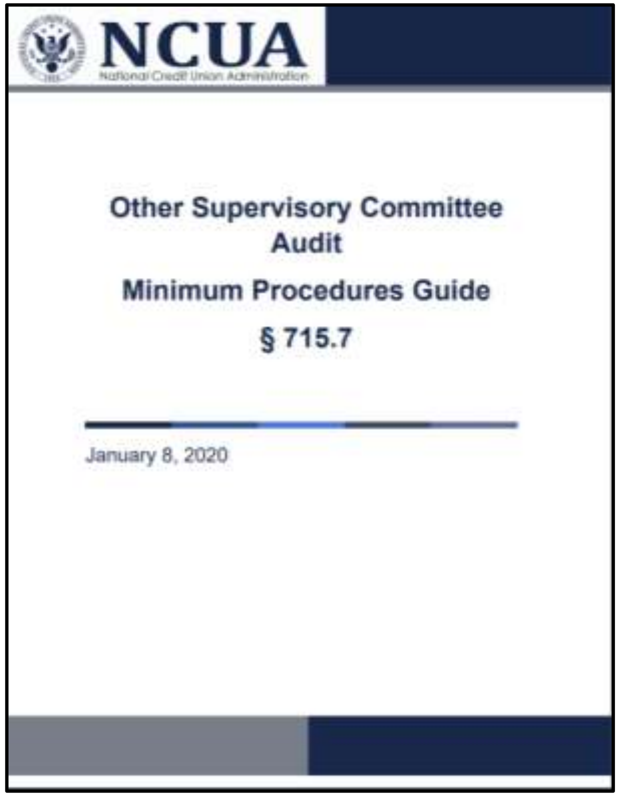
Cons: Expensive

What is an Audit per the Supervisory Committee Minimum Procedure Guide?

It is **not actually an "audit"**:

- Officially an "Agreed Upon Procedure" (AUP)
- Looks at many things an audit would, but it omits many things
  - Doesn't give you an 'opinion'
  - Doesn't look as carefully at internal controls
- Pros: Less expensive than an opinion audit
- Cons: No 'opinion' or 'certification'

It is a very good product for smaller credit unions


NCUA
National Credit Union Administration

Other Supervisory Committee Audit

Minimum Procedures Guide

§ 715.7

January 8, 2020

What are available Audit Opinions?

- Unqualified or "Clean" opinion
  - Presented fairly, namely they are reliable
- Qualified opinion
  - A material misstatement in one particular area that does not have pervasive effect on the financial statements.
  - Auditor was unable to audit an area or balance but it does not have pervasive effect on the financial statements
  - In credit unions, calling 'Deposits' equity
- Adverse opinion
  - financial statements ARE materially misstated

What are available Audit Opinions?

- Disclaimer of opinion
  - Auditor is not independent or when there is conflict of interest
  - Limitation on scope is imposed by client, as a result the auditor is unable to obtain sufficient appropriate audit evidence
  - When the circumstances indicate substantial problem of going concern in client
  - When there are significant uncertainties in the business of client

Steps to a High-Level Audit Liaison Committee

- Know what you need:
  - What you can pay for the audit
- Be open to several firms
- Develop clear RFP
- Hire outside firm carefully
- Let them teach you what they do
- Arrange Executive Session after audit
- Evaluate audit firm
- Evaluate yourselves

"Engagement Letter"
Your Contract with the Auditor

715.9 (b). ***Engagement letter.*** The engagement of a compensated auditor to perform all or a portion of the scope of a financial statement audit or supervisory committee audit shall be evidenced by an engagement letter. In all cases, the engagement must be contracted directly with the Supervisory Committee. The engagement letter must be signed by the compensated auditor and acknowledged therein by the Supervisory Committee prior to commencement of the engagement.

Contents of “Engagement Letter”

1. Specify the terms, conditions, and objectives of the engagement;
2. Identify the basis of accounting to be used; (cash, accrual, other)
3. If an **Other Supervisory Committee Audit**, include an appendix setting forth the procedures to be performed;
4. Specify the rate of, or total, **compensation** to be paid for the audit;
5. Provide that the auditor shall, upon completion of the engagement, deliver to the Supervisory Committee a **written report of the audit** and notice in writing, either within the report or communicated separately, of any **internal control reportable conditions** and/or irregularities or illegal acts, if any, which come to the auditor's attention during the normal course of the audit (i.e., no notice required if none noted);

Contents of "Engagement Letter"

6. Specify a **target date** of delivery of the written reports, so that such target date will enable the credit union to meet its annual audit requirements in this part;
7. Certify that NCUA staff and/or the State credit union supervisor, or designated representatives of each, will be provided unconditional **access** to the complete set of original working papers…
8. Acknowledge that working papers shall be **retained** for a minimum of three years from the date of the written audit report.

d) *Complete scope*. If the engagement is to perform an Other Supervisory Committee Audit intended to fully meet the requirements of §715.7, the engagement letter shall certify that the audit will address at least the minimum requirements in appendix A of this part.

Factors to Consider in Selecting a Firm

- Experience with CUs
- Number of CU Clients
- Firm and individual qualifications
- References
- Number of auditors
- Time in your CU
- Level of staff to be involved

Factors to Consider in Selecting a Firm

- Report delivery date: a report delivery date must be specified in the Engagement Letter.
- Amount of CU staff assistance required
- Peer Review results (Unmodified or Modified report)
- Liability insurance amounts
- Audit fee and additional fees or costs
- Risk management skills

Cost Considerations

- Set your budget
- Obtain competitive bids from several firms
- Never select on price alone
- If the firm you want isn't in your budget, *NEGOTIATE*

When to Change or Replace Auditors

NCUA does **NOT** require auditor rotation

AICPA does **NOT** recommend auditor rotation

- When you believe they are no longer **INDEPENDENT**
  - In Fact
  - In Appearance
- When **service quality** is poor
- When auditor **evaluations** are poor
- When **price** is out of line

At End of Each Audit

- Meet with external auditor privately
  - In Executive Session
- Evaluate the external auditor
  - Ensure continuing INDEPENDENCE…Critical!
- Ensure that management is addressing and documenting their corrections of problems identified by the external auditor
  - Ask the Board to put this step into policy
- Evaluate your Supervisory Committee and the internal audit department

Major Issues in a Management Letter

REPORTABLE CONDITIONS

Reportable conditions refers to a matter coming to the attention of the independent, compensated auditor which, in his or her judgment, represents a significant deficiency in the design or operation of the internal control structure of the credit union, which could adversely affect its ability to record, process, summarize, and report financial data consistent with the representations of management in the financial statements.

Reportable Conditions
If Audit or Exam mentions these…they're big!

1. Material Weakness

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

Reportable Conditions
If Audit or Exam mentions these…they’re big!

2. Significant Deficiency

A deficiency in internal controls less important than a Material Weakness, big enough to warrant reporting to the Governance Team (Board and SC)

Audit Reports and Management's Response

- Management should respond to each audit or examination report **(ask Board to require this in policy)**
  - E.g. Management must submit a written response to all audit comments/findings no later than 30 days after receipt of the audit report by Management. This includes external audits, internal audits, regulatory examinations and other special audits performed by the Supervisory Committee.
- Response should be specific and contain deadlines
- Response should be provided to board and supervisory committee in a timely fashion
- Someone should follow up on all items to verify that they have been corrected
- If management disagrees with finding, they should clearly explain why

Discussions with the Auditor

At the End of Each Audit

- We recommend that the Supervisory Committee meet with the External Auditor for a short **"Executive Session"** at the end of the audit.
- An Executive Session is a private session with only the auditor and the Supervisory Committee present.
- This allows a candid and **frank discussion** of issues with the External Auditor
- THIS SHOULD <u>NOT</u> TAKE PLACE OF THE OPEN EXIT CONFERENCE WITH THE BOARD AND MANAGEMENT PRESENT
  - It is in addition to that.

Questions to ask the external audit firm

- If you had to mention one thing that could **improve the effectiveness of the audit**, what would it be?
- Are there are any potential internal control problems that you discussed with management that are **not included in your written report**?
- Did you issue a separate comments letter to management that was not provided to the supervisory committee?
- Did you **rotate any staff** on the audit job from the year before?
- How do you ensure a **fresh look** each year?

Discussions with External Auditor

Accounting Policies and Practices, Estimates, and Significant Unusual Transactions

- Significant accounting policies and practices
- Critical accounting policies and practices
- Critical accounting estimates
- Significant unusual transactions

Discussions with External Auditor

- Difficult or contentious matters
- Management consultation with other accountants
- Going concern
- Uncorrected and corrected misstatements
- Material written communications with Management
- The Auditor’s Report
- Departure from Standard Report
- Disagreements with management

Discussions with External Auditor

Disagreements with Management

The auditor should communicate to the audit committee any disagreements with management about matters, whether or not satisfactorily resolved, that individually or in the aggregate could be **significant** to the company's financial statements or the auditor's report.

Disagreements with management do not include differences of opinion based on incomplete facts or preliminary information that are later resolved by the auditor obtaining additional relevant facts or information prior to the issuance of the auditor's report.

Discussions with External Auditor

Difficulties Encountered in Performing the Audit

The auditor should inform the audit committee about any serious difficulties encountered in working with management during the audit. Examples include, but are not limited to:

1. Significant delays in management providing required information.
2. An unnecessarily brief time within which to complete the audit.
3. Extensive unexpected effort required to obtain sufficient appropriate audit evidence.
4. The unavailability of expected information. AU §380.35 The Auditor’s Communication With Governance 2091
5. Restrictions imposed on the auditors by management.
6. Management's unwillingness to provide information re: Going Concern

Evaluating the External Auditor

Evaluation of the External Auditor
General Questions

- Did the auditor meet with the audit committee when requested?
- Did the auditor address issues of "**<u>tone at the top</u>**" and antifraud programs and controls in place in the organization?
- Did the auditor inform the audit committee of <u>any risks,</u> of which the committee was not previously aware?
- Did the auditor adequately discuss issues of the quality of financial reporting, including the applicability of new and significant accounting principles?`

Tone at the Top

"Tone at the top" is a term t used to describe an organization's general ethical climate, as established by its board of directors, audit committee, and senior management.

Evaluation of the External Auditor General Questions

- Did the auditor communicate issues freely with the audit committee, or did the auditor seem **protective of management**?
- Does it appear that management exercises undue influence on the **independent** auditor?
- Does it appear that the independent auditor is **reluctant or hesitant** to raise issues that would reflect negatively on management?
- Is the audit committee satisfied with the planning and conduct of the audit, including the financial statements and internal control over financial reporting (as applicable)?

Evaluation of the External Auditor General Questions

- Review all audit-related and non-audit services conducted by the independent auditor in the prior year. Are you satisfied that the independent <u>auditor remains **independent** </u>and objective both in fact and appearance?
- Understand the size of the firm and the book-of-business of the partner-in-charge of the audit. Is the firm, the office or the partner dependent on the organization for a material percentage of its fee income? If so, the audit committee should consider whether <u>this impairs the appearance of **independence** </u>with respect to the organization.

Evaluation of the External Auditor General Questions

- Is the audit committee satisfied with its relationship with the auditor?
  - (*a*) Did partner-in-charge of the audit participate in audit committee meetings,
  - (*b*) Were auditors frank and complete in the required discussions with the audit committee,
  - (c) Was auditor frank and complete during executive sessions with the audit committee,
  - (*d*) Was auditor on-time in their delivery of services to the company.
- Was the audit fee fair and reasonable in relation to what audit committees know about fees charged to other companies?

Evaluation of the External Auditor General Questions

- Did the **independent** auditor provide <u>constructive observations</u>, implications, and recommendations in areas needing improvement, particularly with respect to the organization's internal control system over financial reporting?

Evaluation of the External Auditor Audit Liaison/CFO/CEO

Did the **independent** auditor work with you to ensure <u>the coordination of audit efforts</u> to assure the completeness of coverage, reduction of redundant efforts, and the effective use of audit resources?

a) Are you satisfied with the knowledge, skills, and abilities of the staff assigned to do the audit work?
b) Was cooperative work conducted in the spirit of professionalism and mutual respect?

Evaluation of the External Auditor Audit Liaison/CFO/CEO

From your perspective in working with the independent auditor, <u>are you satisfied</u> with the scope, nature, extent, and timing of testing performed by the independent auditor?

Are you satisfied that the independent <u>auditor remains</u> <u>**independent**</u> of the company in spite of any audit-related, or non-audit services the auditor provides to the organization?

Evaluation of the External Auditor Audit Liaison/CFO/CEO

a. Are you aware of any other information that might impair the **independence** of the independent audit firm?
b. Are you aware of any individuals on the audit team that might not be **independent** with respect to the company for whatever reason?
c. If the choice were yours, would you hire the firm to conduct next year's audit?
d. If so, what changes would you make?
e. If not, why not?

Internal Controls and the Supervisory Committee

Internal Controls: Fraud and Error

A system of checks and balances that help prevent error or fraud or quickly identify error or fraud after it occurs.

Internal Controls: The SC Role

The role of the Supervisory Committee is:

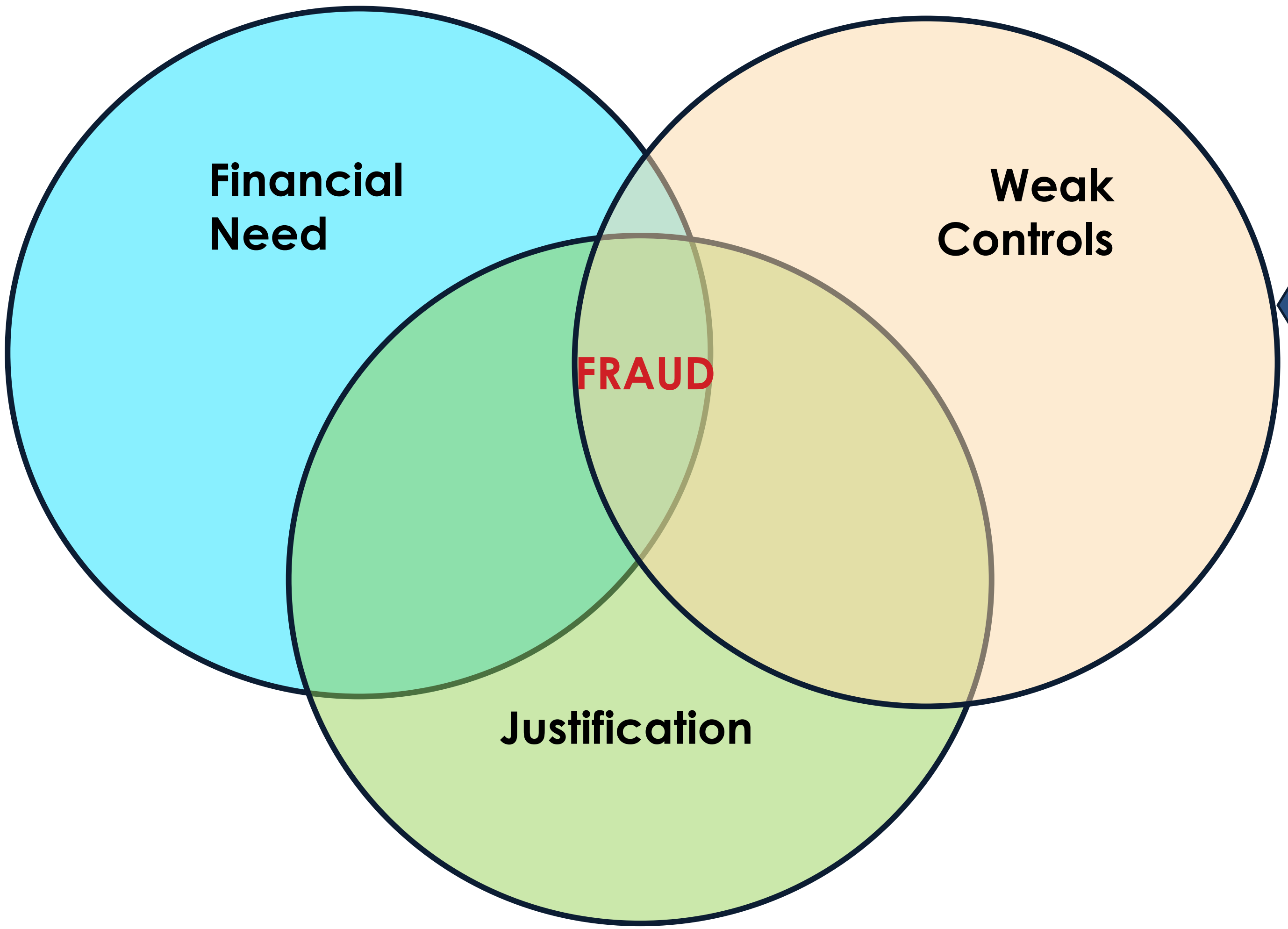
1. Hire a competent outside Audit Firm
2. Create process to ask management how they perform the following internal control procedures.
3. Test if necessary

Internal Controls: Fraud and Error

Error is much more common than fraud.

A good system of internal controls is
best protection from both.

Fraud Triangle



This is the part we have some control over

Who Commits Fraud?

Internal	**External**
Management	Employee Family Members
Officials	Vendors
Employees (most common)	Outsiders (most dangerous)
	Members

Everybody gets into the act

Cash

Teller drawer cash and vault cash

"Taking work home with them."

Problem: Embezzling cash from drawer.

Cash:
Risk Level - Low

Inherently Attractive…but controls usually among the best

Problem Area: Teller drawer cash, recycler cash and vault cash

Controls: Perform periodic cash counts

- Require individual control of funds by teller (spare key under dual control)
- Require dual control over cash dispenser funds
- Require dual control of vault funds (no individual should be able to access the vault individually)
- Require dual control of the keys and combination
- Policy limits on amount teller can maintain in drawer

***Problem area:* Employees embezzling non-cash items such as gift cards, tickets**

Controls:

- Perform periodic counts
- Maintain up-to-date logs of all non-cash items
- Provide dual control of non-cash items

***Problem Area:* Employees removing cash from cartridges or cash dispensers or deposits from ATM machines or night drop during servicing**

Controls:

- Require dual control whenever the ATM, cash dispenser or night-drop is accessed
- Perform periodic counts of cash in the ATM cartridges or cash dispenser

Cash Counts

Purpose:

- **Ascertain that cash exists in amounts recorded**
- **Emphasize that precision is important**
- **Emphasize that controls do exist**
- **Ensure that teller balancing sheets agree with the general ledger**

1. Count before opening in the morning
2. Make sure CU employee observes your count
3. Include tickets and other non-cash items
4. Compare teller balance to the amount recorded in general ledger

Loans and Credit Cards:
Risk Level – Medium to High

Problem Area:

- Employee setting up false or unauthorized loans
- Eliminating loan balances
- Advancing due dates on loans to avoid repayments
  - Hiding Delinquency
- Changing interest rates or other terms

Loans and Credit Cards:
Risk Level – Medium to High

Controls:

- Block ability of employees to access their own accounts
- Review employee and employee family member accounts
- Regularly review exception reports
- Regularly review File Maintenance Report, changes made to "critical fields", e.g., terms, names, addresses
- Proper segregation of duties
  (1 of 4 steps by unique individual)
  1. Intake 2. Underwriting 3. Funding 4. Payments

Loan Exception Reports

Purpose:

Various standard or special reports that identify loans that have something unusual

1. Loans Paid Ahead Report
2. Loans with Low Interest Report
3. Loans with Accrued Interest Exceeding Payment
4. Loans with Current Balance Exceeding Original Balance

Loans Paid Ahead Report

1. Looking for error OR fraud
2. Find out what has caused loan to be paid ahead
3. If member paid loan ahead, your contract (Note and Disclosure) still requires payment every month
4. This report should be reviewed by management and "next due" date should be returned to contractual due date.
5. Only effective as an internal control tool if it is kept 'cleaned up'

Loans Paid Ahead Report

Member Name	Next Due	Last Paid
Willie Payit	11/15/x3	4/7/x2
Betty Wont	12/16/x3	10/9/x2

Who is watching this report and cleaning it up monthly?

Loans with Low Interest Rate

1. Looking for error OR fraud
2. Looking for loans with interest rates lower than approved rates for that loan type
3. Report should include "loan type"

Loans with Low Interest Rate

Member Name	Loan type	Origination Date	Interest Rate
Howie Didit	New Car	3/9/x2	0.10%
Shirley Lowe	Signature	5/15/x2	0.90%

Did the CU ever offer loan rates this low?
If not, you may have fraud or error showing up

Loans with Accrued Interest Exceeding Monthly Payment

1. Looking for error OR fraud
2. May indicate loans for which payments have not been received for some time
3. Loan should either be delinquent or on Paid Ahead Loans Report
4. If not, may need to investigate

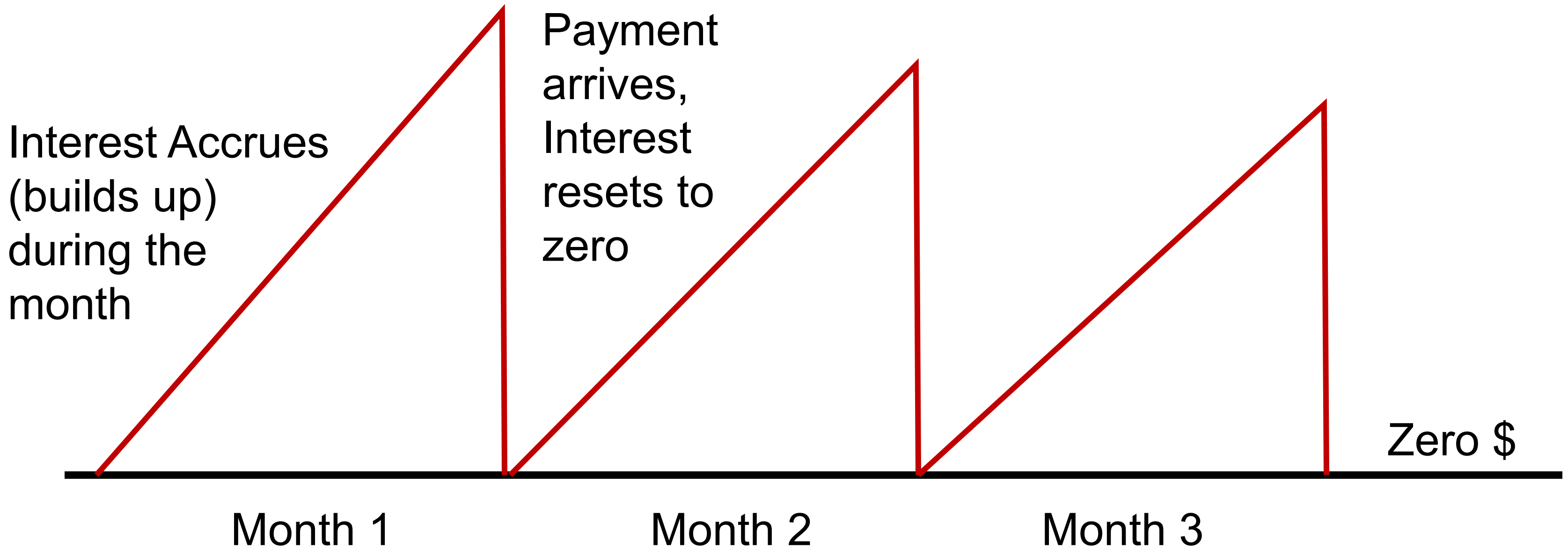
Loans with Accrued Interest Exceeding Monthly Payment

Member Name	Orig Date	Ln Type	Accr'd Interest	Monthly Payment	Last Paid
Justa Deadbeat	8/12/x2	Auto	565.05	321.15	2/5/x2
Dewey Cheatham	7/23/x1	RE	1125.03	716.09	2/15/x3

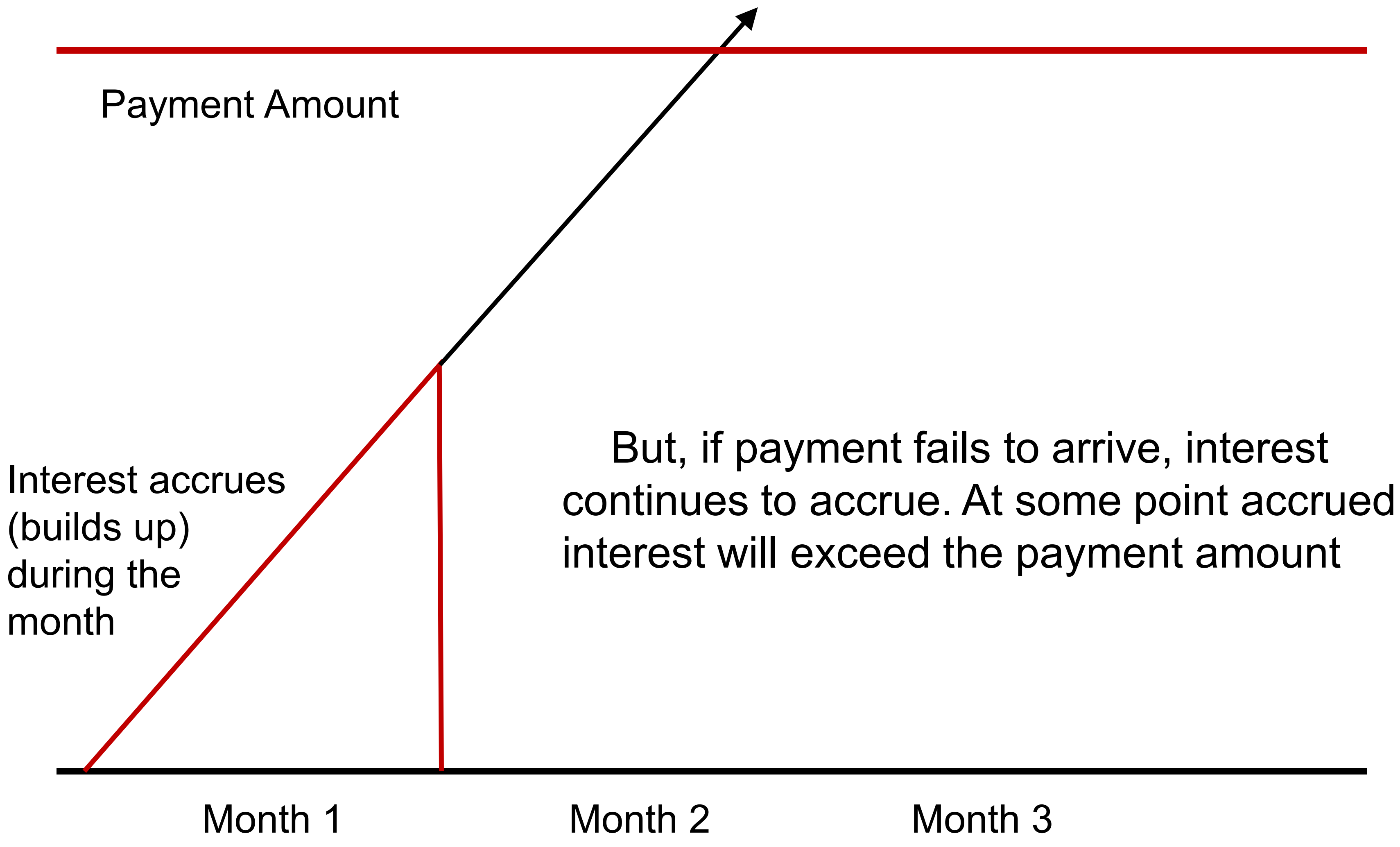
Are these loans on the Delinquency Report or Loans Paid Ahead Report?

- If yes, good, the system is working
- If not, we may have a problem. Why not?

Loans with Accrued Interest Exceeding Monthly Payment



Loans with Accrued Interest Exceeding Monthly Payment



Loans with Current Balance Exceeding Original Balance

1. Looking for error OR fraud
2. Need to find out why loan is not amortizing (declining)
3. Could be input problem
4. Could be insurance or other addition
5. Could be employee manipulating a loan

Loans with Current Balance Exceeding Original Balance

Member Name	Ln Type	Orig Date	Last Paid	Orig Balance	Current Balance
Howie Beatsem	Auto	5/10/x2	5/12/x3	26,205.15	27,319.19
Carla Crook	Sig	6/12/x2	4/30/x3	1,256.25	1,310.25

Aren't loan balances supposed to go down over time? Oh, Yeah, they are!

Report of Accounts with Same Address

1. Could indicate a group of accounts that have been fraudulently taken over with all statements going to a single controlled address.
2. Look for same address with different last names
3. Be aware of many other situations that could cause this circumstance:
   - Family circumstance
   - Shared address

Report of Accounts with Same Address

Member Name	Address	City	ST	Phone
Desire Swirst	2554 Ranch Road	Lincoln	NV	702-999-9999
Strand Flibert	2554 Ranch Road	Lincoln	NV	702-999-9999
Cha Cha Sanchez	2554 Ranch Road	Lincoln	NV	702-999-9999
Shanteay Wenzel	2554 Ranch Road	Lincoln	NV	702-999-9999
Lolita Eberg	2554 Ranch Road	Lincoln	NV	702-999-9999

Negative Share Balance Report

1. Look for employee or family member names
2. Report should indicate when account became negative
3. Find out how management "works" these accounts, often "worked" like collections accounts

Checking/Payment Accounts

Risk Level – Medium to High

Problem Area:

- **Employees manipulating their own or members' accounts**
- **Depositing bad checks or falsifying deposits**
- **Depositing member's funds in own account**
- **Kiting**
  - Automated alerts for members who deposit large checks and immediately withdraw funds before they clear.
- **Over-drafting own account**

***Controls*:**

- Review employee and employee family accounts
- Carefully perform the Member Verification
- Review Report of Negative Share Balances

Dormant or Inactive Accounts
Risk Level - High

Problem Area:
Employee making unauthorized withdrawals from or unauthorized loans to dormant or inactive accounts for the employee's benefit

Controls: Review activity on Dormant Accounts Report

Activity on Dormant or Inactive Accounts

1. **Inactive**: No activity in last 12 months
2. **Dormant**: No activity in State's ESCHEAT period

Look For:

- New Loans
- Withdrawals
- Transfers out to other accounts
- Small deposits into account

(could be used to create activity thus removing account from protection, followed by a fraudulent withdrawal)

General Ledger Accounts
Risk Level: Varies
Balance Sheet, Income Statement, Suspense

***Problem Area:* Embezzling funds, hide posting of withdrawal in General Ledger and fail to properly reconcile the affected accounts allowing embezzlement to remain disguised**

Controls:

- Require timely and complete reconciliations every month
- Require that all reconciliations are reviewed and approved by someone senior to the preparer
- Limit posting authority to key employees
- Perform a periodic review of Balance Sheet and expense account activity

Repossessed Collateral
Risk Level – Medium to High

Problem Area:

- Employee selling repossessed collateral at a discount to friends or family
- Employee personally using repossessed collateral
- Selling through dealers who pay kickbacks to the employee

Repossessed Collateral
Risk Level – Medium to High

Controls:

- Require organized and well-documented bidding process on sales
- Segregate duties among at least 2 different people in this sales process
- Review sales after-the-fact
- Review Report of Status of Repossessed Collateral
- Prohibit these actions in policy
- Require organized and well-documented dealer selection process (if collateral sold by dealer)

Investments
Risk Level - Low

Problem Area:

- **Employee setting up false investments and misdirecting investment funds for personal use**
- **Misdirecting portion of the interest received for personal use**
- **Investing funds with brokers who provide kickbacks**

***Controls*:**

- Require dual control of investments (two people must authorize transactions)
- Periodically confirm the existence and terms of the investments (part of annual audit)
- Set up a selection and review criteria for brokers (required by Regulation 703)

Investments
Risk Level - Low

Problem Area:

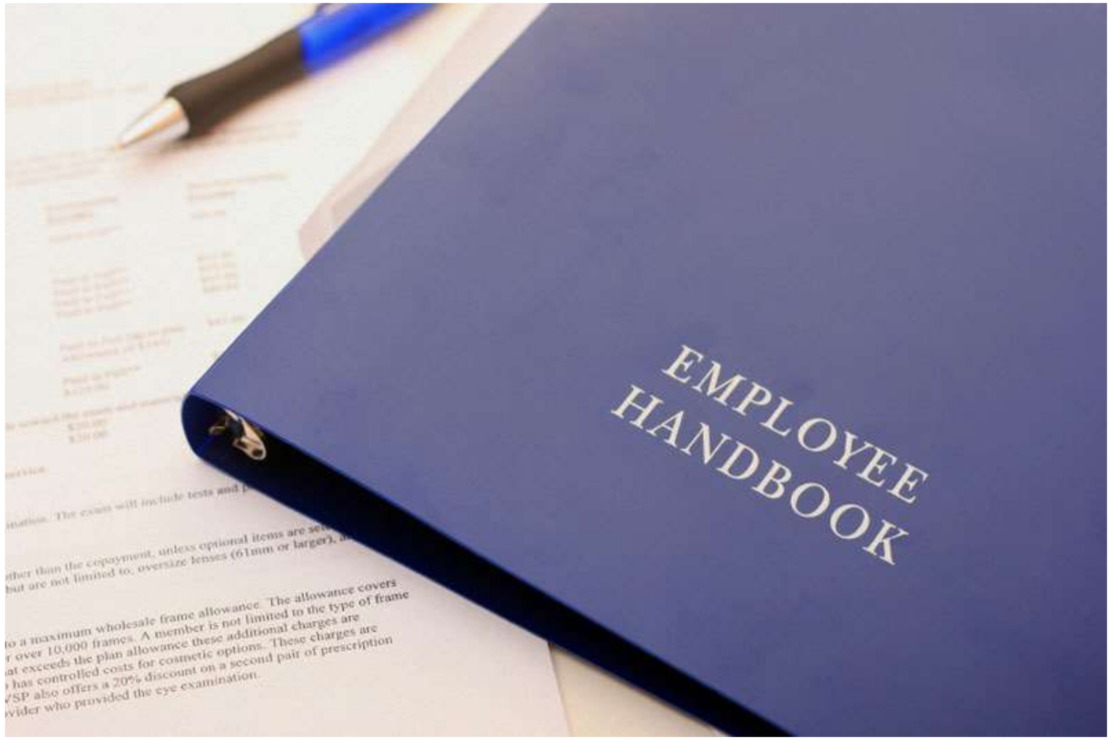
- **Market value of investments is below face-value and the amount of loss not being recognized by management or disclosed to the Board**

Controls:

- Ensure that the market value of investments is reviewed and that market values are obtained from a reliable source

Reviewing Employee Accounts

1. Fictitious or unauthorized loans
2. Unauthorized withdrawals from general ledger accounts
3. Unauthorized withdrawals from other members' accounts
4. Kiting of checks



Reviewing Employee Accounts
Loans

1. Was new loan properly authorized?
2. Are terms and conditions within policy?
3. Are payments being paid timely?

Reviewing Employee Accounts
Deposits

1. Verify transfers into the account from other accounts
2. Verify transfers into the account from general ledger accounts
3. Look for reversed fees or uncharged fees
4. Look for an unusual number of checks and deposits (could indicate kiting)

Reviewing Employee Expense Reimbursements

1. Obtain copy of employee expense reports and review a sample of receipts for legitimate business purpose
2. Obtain a copy of the corporate credit card statement and compare charges with receipts for legitimate business purpose.

Different Roles in Internal Controls

- *The **Board** Establishes Strategic Direction, Policy and Tone at the Top*
- ***Management** Establishes Procedures, Controls & Quality Assessments and Supervision*
- ***Employees** Interact with Members and Complete Day to Day Operations following the Internal Controls*
- ***Supervisory Committee** Evaluates the Process including Internal controls via External Audit*

Fraud or Ethics Reporting Hotlines

Verification of Accounts

- Controlled verification
  - 100% of loan and share accounts
  - Usually a ‘Negative Verification’
    - Member contacts you only if there is problem
- Statistical method
  - Random sample
  - Usually a ‘Positive Verification’
    - CU must receive response or perform ‘alternative procedures’

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