



Supervisory Committee Guide for Federal Credit Unions

NATIONAL CREDIT UNION ADMINISTRATION

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Chapter 1 -- INTRODUCTION

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- 1.02 What approach have you taken in revising the Guide ?**
- 1.03 Who will benefit most from this Guide ?**
- 1.04 Does this Guide apply to FISCUs?**
- 1.05 Is this Guide directed to the credit union having a manual or automated system?**
- 1.06 Is this Guide all we need?**

Why update this Guide?

1.01 This Guide updates our previous publication dated May 1997. It incorporates changes in the Federal Credit Union Act required by the Credit Union Membership Access Act of 1998 and amendments to the related regulations governing credit union supervisory committee audits and verifications amended by the NCUA Board on [date]. It conveys information and provides clarifications to credit union officials and management, although it doesn't have the force and effect of a regulation.

What approach have you taken in revising the Guide?

1.02 The Guide is useful to credit unions with a non-complex structure, and usually a smaller asset size. It is a burden for them to obtain the services of a compensated qualified auditor to assist them in conducting the annual supervisory committee audit. It will be most helpful to the volunteer in a credit union operating in an elementary data processing environment. We have used a "plain English" question and answer format throughout this Guide.

Survey Results. A survey conducted previously indicated that:

- For guidance in meeting the audit and verification requirements, you most rely on your external auditor, the *Supervisory Committee Guide*, and the NCUA examiner, in that order.

NOTE: This *Guide* is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the *Federal Credit Union Act* and the *NCUA Rules and Regulations* §715.

- You felt the need for such a Guide continues to exist, in its present form but supplemented by an electronic format, and issued by the federal regulator.
 - You felt the targeted audience should continue to be credit union volunteers, primarily untrained volunteers.
 - You were split on whether the Guide should be a general reference tool directing users to others sources or a stand-alone document.
 - You felt that existing professional guidance (FASB, AICPA, etc.) was too technical, of little direct usefulness and in need of supplement.
 - You wished to retain the freedom to develop your own audit program and choose your own reporting format within parameters.
 - Topics you recommended for addition and expansion in the revised Guide include: auditing in a computer environment; internal controls and security measures; comprehensive program of internal auditing; updated forms and checklists; fraud and risk assessment guidelines; materiality guidelines; discussion of legal liability; etc.
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Who will benefit most from this Guide ?

1.03 Supervisory committee members, like yourselves, especially those new to their positions, can use this Guide to get a sound overall introduction to their duties. Better informed and guided committee members will help ensure the credit union operates safely and soundly. A safe and sound credit union can provide the best possible service to its members.

Boards of directors can be assured the supervisory committee audits are thorough. Identification of a problem is the crucial first step to correcting the problem.

Professional auditors can gain additional understanding of

what NCUA contemplates as necessary and appropriate, which can enhance their audit planning and scope-setting process.

Regulators and insurers can achieve a higher confidence level in the accuracy of the financial data regularly reported for their review and/or monitoring.

Does this Guide apply to FISCUs?

1.04 This Guide is written for Federal credit unions. Certain parts of the Guide briefly mention federally insured state chartered credit unions (FISCUs) but the Guide does not include a full discussion of FISCU matters. Nonetheless, FISCUs may find it a handy reference tool if supplemented with guidance available through your state supervisory authority.

Is this Guide directed to the credit union having a manual or automated system?

1.05 We have directed the Guide to the credit union having an automated system. Almost all credit unions have at least their share and loan accounts on computers. To automate the rest of the bookkeeping beyond this point takes very little extra effort.

Statistics. As of June 30, 1998, only 4.0 percent (447) of federally insured credit unions reported they were still on manual recordkeeping systems. Of these (402) are less than \$2 million asset size. Many of these credit unions will become automated over the next few years as commercial software for full bookkeeping becomes even more refined and “user friendly,” and the costs continue to decline.

If your credit union *isn't* already automated, you should be sure to review Chapter 7 for guidance on some key issues in hand-posted recordkeeping. We've also added some comments about auditing when not automated in some of the chapters and at the end of the instructions for many of the sample workpapers.

Is this Guide all we need?

1.06 The following Guide does not attempt to address every possible situation that you may encounter, and we do not contend that many of the procedures described are the only ones you can use. Procedures appropriate for your credit union may vary widely from those of another credit union. Therefore, you must plan and carry out your duties in a manner consistent with and responsive to your particular situation and needs.

Chapter 2 -- WHAT IS A SUPERVISORY COMMITTEE?

- 2.01 What is a supervisory committee?**
- 2.02 How is the supervisory committee appointed?**
- 2.03 What are the qualifications to be appointed to the committee?**
- 2.04 What actions may the supervisory committee take with other board and committee members?**
- 2.05 Who is required to maintain records of all actions taken by the supervisory committee?**
- 2.06 Is credit union information confidential?**

What is a supervisory committee?

2.01 Part 715 of the NCUA Rules and Regulation defines a supervisory committee consistent with Section 111(b) of the *Federal Credit Union Act*, 12 U.S.C. 1786(r):

“The supervisory committee shall be appointed by the board of directors and shall consist of not less than three members nor more than five members, one of whom may be a director other than the compensated officer of the board . . .”

For some federally-insured, state chartered credit unions (FISCUs), the “audit committee” designated by state statute or regulation is the equivalent of a supervisory committee. This *Guide* is for use by all federally insured credit unions but state chartered credit unions must look to state law to identify certain specific differences. §741 of the NCUA Rules and Regulations applies to FISCUs.

NOTE: This *Guide* is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the *Federal Credit Union Act* and the *NCUA Rules and Regulations* §715.

How is the supervisory committee appointed?

2.02 The board of directors appoints the supervisory committee, determining the number of committee members and the term of service.

Number of committee members. The board of directors determines the number of members on the committee. The minimum number of members on the committee is three; the maximum is five.

Term of service. The board of directors determines the term.

- The terms are for one, two, or three years.
- All terms must be for the same number of years in total.
- Terms should be staggered with one position up for appointment each year thus providing continuity to the committee.
- The regular terms expire after the first regular board meeting following the annual meeting.

One member of the supervisory committee may be a director other than a compensated officer.

Committee leadership. The committee members select a chairperson and a secretary. The offices of chairperson and secretary may be held by the same person.

What are the qualifications to be appointed to the committee?

2.03 You, a supervisory committee appointee/member:

- Must be a member of the credit union.
 - Must be bondable by the credit union's surety bond company (all credit union officials and employees must
-

be bondable).

Employees and credit committee members are not eligible for membership on the committee as outlined in the FCU Bylaws.

Experience in bookkeeping, accounting, or auditing is helpful in carrying out your responsibilities for the audit and verification.

The following individuals are prohibited from supervisory committee service by principles of sound internal control:

- Loan officer.
 - Membership officer.
 - Treasurer/Assistant treasurer.
 - President/Vice president.
 - Secretary.
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What actions may the supervisory committee take with other board and committee members?

2.04 You may suspend, by unanimous vote, any board member, executive officer, or credit committee member. (See below). Suspension is a serious measure and must be thoroughly considered before action is taken.

- If you suspend someone, you will call 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.

You may call a special meeting (by a majority vote) to consider any violation of the:

- FCU Act.
 - Rules and Regulations.
 - Charter.
-

- Bylaws.
- Any practice considered unsafe or unauthorized.

Attendance at Board meetings. Oftentimes supervisory committee members have asked NCUA if they are required/entitled to attend Board meetings. We encourage at least one supervisory committee representative to attend each board meeting. While the supervisory committee may attend such meetings, attendance is permitted only with the permission of the board; the committee members do not have an unqualified right to be present.

The board must publish minutes and the minutes must be available to the supervisory committee for its (or its designee) review.

Who is required to maintain records of all actions taken by the supervisory committee?

2.05 The secretary must maintain records of all actions taken.

- Monthly or quarterly meeting minutes should be completed, based on the complexity and financial condition of the credit union.
- The minutes should document significant discussions and summarize procedures performed.

Minutes should be approved by the committee at the next scheduled meeting.

Is credit union information confidential?

2.06 Yes, you must keep any information obtained about the credit union and member account records confidential.

Chapter 3 -- WHAT STANDARDS MUST WE MEET IN PERFORMING THE AUDIT AND VERIFICATION?

- 3.01 What standards must we meet in performing the audit and verification?**
- 3.02 How qualified do we have to be?**
- 3.03 How accurate must we be?**
- 3.04 How do we control the work?**
- 3.05 How much detail must we go into?**
- 3.06 What files must we make and keep?**
- 3.07 What is “independence” and must we be independent?**
- 3.08 What happens if we fall short of these standards?**

What standards must we meet in performing the audit and verification?

3.01 §715 of the NCUA Rules and Regulations sets forth supervisory committee audit requirements and standards consistent with the Credit Union Membership Access Act (CUMAA). The requirements and standards are linked to asset size and type of audit¹:

- Federally insured credit unions with assets of \$500 million or greater must obtain a financial statement audit consistent with generally accepted auditing standards (GAAS) by an independent certified public accountant or public accountant licensed by the appropriate State or jurisdiction to perform those services.
- Federal credit unions with assets less than \$500 million but more than \$10 million may obtain a financial statement audit (as above); a balance sheet audit; a report on the examination of internal control over call reporting under attestation standards; or an audit consistent with this *Guide*.
- Federally insured credit unions with less than \$10 million in

¹ Any federal credit union regardless of asset size can fulfill its supervisory committee audit responsibility by obtaining a financial statement audit.

NOTE: This *Guide* is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the *Federal Credit Union Act* and the *NCUA Rules and Regulations* §715.

assets may obtain a balance sheet audit; a report on the examination of internal control over call reporting under attestation standards; or an audit consistent with this *Guide*.

In addition, §715 requires that any compensated auditor you hire be independent.

“Federal credit union compensated auditors performing audits for supervisory committees, must be independent of the credit union’s employees, members of the board of directors, supervisory and credit committees and/or the credit union’s loan officers, and members of their immediate families.”

How qualified do we have to be?

3.02 Your appointment by the board reflects the board’s confidence in your integrity and in your ability to assume this position of responsibility in safeguarding the credit union’s assets and protecting the interests of the members. The board will have selected members who have the best backgrounds available and who are interested in the credit union as well as the functions of the committee. You can acquire the special knowledge and skills to do a credible job if you have a genuine interest in acquiring them. It is up to you to achieve a satisfactory level of proficiency in carrying out your responsibilities. You can accomplish this by reading, observing and actually performing the audit steps.

To be a committee member, you should have accounting knowledge. For example, you probably don’t need an accounting degree to audit a credit union of small asset size offering core services only, but you almost always would need prior experience with double-entry bookkeeping.

Also you need to have an understanding of auditing procedures. You must understand internal controls, be able to test controls, complete the annual audit, and verify members’ accounts to insure that proper procedures are followed in the gathering of data and

evaluating results. If experience and understanding are lacking, you and the committee should seek sufficient training or the assistance of an outside professional who can perform the function in a competent manner.

References and Resources Available. In addition to this Guide, you should consult a number of references and resources:

- (a) *FEDERAL CREDIT UNION ACT, BYLAWS, RULES AND REGULATIONS AND CHARTER.* - The Act and Bylaws state the purposes and functions of federal credit unions and define the responsibilities of the officers, directors, and committees. The Rules and Regulations further outline the conditions under which the functions permitted by the Act may be carried out. Another document, the credit union's charter, sets forth the field of membership thereby identifying who is eligible to become members of the credit union. You must have an understanding of these references in order to effectively perform your responsibilities.
 - (b) *ACCOUNTING MANUAL FOR FEDERAL CREDIT UNIONS.* - Basic accounting procedures recommended for credit unions under \$10 million in assets by the National Credit Union Administration are set forth in this publication.
 - (c) *CONFERENCES WITH THE FEDERAL CREDIT UNION EXAMINER.* - The examiners should always be considered an available resource to help you. During federal supervisory examinations, the examiner analyzes the supervisory committee's performance and will arrange a conference with one or more members of the supervisory committee as part of that analysis process. At these conferences the examiner may offer helpful suggestions to you concerning the committee's work.
 - d) *GENERAL OBSERVATION OF OPERATIONS.* - You can learn a great deal about your credit union by observing its day-to-day operations and by attending meetings of the board of directors and credit committee.
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- e) *ATTENDANCE AT TRADE ASSOCIATION MEETINGS.* - Experience has shown that credit union officials can broaden their perspective, improve their competence, and get more satisfaction from credit union work by taking an active part in trade association functions.

 - f) *PARTICIPATION IN TRAINING CLASSES.* - Trade associations conduct educational classes for supervisory committee members from time to time. These educational classes have the flexibility to be of help to both experienced and new committee members. In most areas, classes for supervisory committee members can be arranged if there is sufficient interest and participation.

 - g) *TRAINING FROM SOURCES OUTSIDE CREDIT UNIONS.* - You may wish to go beyond the scope of training materials specifically designed for credit unions. Some committee members enroll in evening classes in accounting and auditing and others may subscribe to correspondence courses in this field.
-

How accurate must we be?

3.03 You must undertake the audit and verification with good faith and integrity. A reasonable number of “human errors” is acceptable, but shouldn’t occur often enough to affect the overall results and conclusions you reach.

How do we control the work?

3.04 Plan your work adequately. Audit planning involves developing an overall strategy for the conduct and scope of the audit. Develop more detailed plans to address more complex issues. Audit planning is discussed more fully in Chapter 7.

Common sense requires that you properly supervise any assistants you use for tasks such as verifications of members’ accounts or periodic cash counts. This means:

- (a) Directing the efforts of assistants who are involved in accom-
-

plishing the objectives of the audit and determining whether those objectives were accomplished. Elements of supervision include instructing assistants, keeping informed of significant problems encountered, reviewing the work performed, and dealing with differences of opinion among personnel.

- (b) Assistants should be informed of their responsibilities and the objectives of the procedures that they are to perform.
 - (c) The work performed by each assistant should be reviewed to determine whether it was adequately performed and to evaluate whether the results are consistent with the conclusions presented in your report.
-

How much detail must we go into?

3.05 The internal control structure, size, complexity, and financial stability of your credit union will influence the extent of your review. You can use the checklists provided later in this *Guide* to assess the strength of the credit union's internal controls, either as part of an annual audit or according to an annual schedule of tasks you can develop. We have also provided sample audit steps and working papers to assist you in planning your audit.

Licensed compensated auditors retained to perform committee activities are expected to adhere to generally accepted auditing standards (GAAS) of the American Institute of Certified Public Accountants (AICPA).

What files must we make and keep?

3.06 Keep all underlying account data and all corroborating evidence available to you. Evidence includes copies of books of original entry, the general and subsidiary ledgers, related accounting manuals, and such informal and memorandum records as work sheets supporting cost allocations, computations, and reconciliations. Corroborating evidence includes checks, invoices, contracts, and minutes of meetings; confirmations and other written representations; information you obtain from inquiry, observation,

inspection, and physical examination; etc.

The committee must maintain or make available to NCUA a complete set of the original audit working papers in support of the audit and verification. If you use an independent compensated auditor, you must ensure NCUA staff has unconditional access to the working papers for inspection upon request, at either the offices of the credit union or at a mutually agreeable location. This requirement should be stipulated in the auditor's engagement letter.

Working papers refers to,

“. . .the principal record, in any form, of the work performed during the audit to support the findings and conclusions. The definition of working papers includes the written record of procedures applied, tests performed, information obtained, and pertinent conclusions reached during the audit. Also included in the definition is an independent and compensated auditor's proprietary audit program, analysis, memoranda, letters of confirmation and representation, abstracts of credit union documents, any retained reviewer's notes, and all schedules and commentaries.”

**What is
“independence”
and must we be
independent?**

3.07 “Independence” and “independent” means exercising,

“. . . the impartiality necessary for the reliability of the compensated auditor's findings. Independence requires the exercise of fairness toward credit union officials, members, creditors and others who may rely upon the supervisory committee audit report.”

You, too, must be certain that you remain objective and free from influences that may impair your objectivity. If you can't act in an independent manner, your opinions have less value. If for some reason you or a member of the committee is, or is perceived to be, unable to objectively perform a specific duty, it is your responsibility and the committee's responsibility as a whole to determine that the

task is performed by a committee member who can act independently. Without independence, the credibility of the data gathered and/or the conclusions reached are questionable.

What happens if we fall short of these standards?

3.08 You'll typically get a reasonable chance to either make corrections or improve your future work. Federal examiners or your state supervisor typically will advise you of the additional work necessary to comply with §715 and provide you from 30 to 60 days to bring the audit or verification into compliance.

If NCUA or your state supervisor is not satisfied with your work or should the credit union fail to correct deficiencies within a reasonable period of time, you may be required to hire outside assistance (See NCUA Rules and Regulations, §715.)

Inability or unwillingness to fulfill the duties of your office can only bring harm to the credit union and its members/owners. If this is the situation you find yourself in, you may wish, in the best interests of all, to step aside. If you choose not to step aside under certain circumstances (bad faith, negligence, dishonesty, etc.) NCUA can impose sanctions against the supervisory committee members and penalties against the credit union.

CHAPTER 4 -- WHAT ARE OUR RESPONSIBILITIES?

- 4.01 What are our goals and responsibilities?
- 4.02 What, then, must we do?
- 4.03 What should we know about the annual audit?
- 4.04 What should we know about the verification of member's accounts?
- 4.05 How do we ensure that the board of directors is safeguarding assets, and that management complies with its policies and plans?
- 4.06 What are internal controls and how do we review them?
- 4.07 How do we manage and structure an internal audit function?
- 4.08 How do we manage and structure an external audit function?
- 4.09 What should we consider when looking at internal versus external auditing?
- 4.10 How do we follow-up on examinations and audits?
- 4.11 What should we expect when meeting with the federal examiner?
- 4.12 How do we handle member complaints?
- 4.13 What other procedures should we consider?
- 4.14 Are there any other resources we can use?
- 4.15 What records can we access?
- 4.16 What do we need to document?
- 4.17 What if we find problems?
- 4.18 How do we coordinate our plans into a program?

Appendix

Sample Supervisory Committee Workplan

What are our goals and responsibilities?

- 4.01** You, the supervisory committee, have two general goals. You must ensure that:
- (a) Management's financial reporting objectives have been met.

NOTE: This *Guide* is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the *Federal Credit Union Act* and the *NCUA Rules and Regulations* §715.

- (b) Management practices and procedures safeguard members' assets.

To meet these two general goals, you are responsible for determining whether your credit union managers have:

- a) Established and maintained effective internal controls to achieve the credit union's financial reporting objectives. These controls must meet the requirements of the supervisory committee audit, verification of members' accounts and your additional responsibilities. See 4.06 for a definition of internal controls.
- (b) Promptly prepared accounting records and financial reports to accurately reflect operations and results.
- (c) Properly administered the relevant plans, policies, and control procedures established by the board of directors.
- (d) Established policies and control procedures that safeguard against error, carelessness, conflict of interest, self-dealing and fraud.

You make those determinations primarily through conducting audits and verifications.

**What, then,
must we do?**

4.02 At least once every calendar year, you must complete (or have completed) the supervisory committee audit, and provide a report on the audit to the board of directors. The audit must cover the period elapsed since the last audit period.

At least once every two years, you must conduct a verification of members' accounts.

You must ensure that the board of directors is safeguarding assets, and that management complies with their policies and plans.

You must report to members at the annual meetings as stipulated in Article V of the standard bylaws.

You also should:

- Review internal controls.
- Hire and work with an internal auditor (if feasible for the credit union).
- Hire and work with the external auditor (if feasible for the credit union).
- Review examination and audit findings and follow-up to ensure that management takes the necessary corrective action. The action taken must be adequate to correct the findings.
- Meet with the federal examiner as you or the examiner may request.
- Research member complaints.
- Complete other recommended procedures.

While your responsibilities encompass a range of areas, the depth of your review can vary. The internal control structure, size, complexity, and financial stability of your credit union will influence the extent of your review.

The supervisory committee serves a very important function in smaller credit unions in particular, because of limited internal controls. Smaller credit unions have fewer staff members and they cannot segregate job responsibilities well. Supervisory committee functions help to compensate for limited controls.

Active supervisory committees help to improve the credit union.

What should we know about the annual audit?

4.03 You must complete the audit at least once each calendar year. During the audit, you must review the structure of the credit union's internal controls and verify the accuracy of the credit union's records. You must prepare a report of your findings and present the final audit report to the board of directors.

If you wish to undertake the audit yourself, this *Guide* provides basic audit steps. You may also choose to hire outside assistance to complete the audit for you.

- *Chapter 5* addresses factors to consider in either case.
- *Chapter 6* addresses use of an internal auditor.
- *Chapters 7 and beyond* provides guidance on completing the audit yourself.

The NCUA examiner may review the audit workpapers during the federal examination.

What should we know about the verification of members' accounts?

4.04 You must complete a verification of all members' accounts once every two years. This could entail simply requesting the data processor to include a section on the member's statement regarding the verification. However, there are other control issues.

- *Chapter 24* fully describes the verification of accounts.

"*Verifying member accounts*" simply means requesting members to respond to you if the activity or balances on their statements are not accurate. The purpose of the verification is to detect errors, and it is also a good control to prevent fraud. Sometimes a verification is called a confirmation.

Closed Accounts. The purpose of verifying closed accounts is again to detect errors, and guard against fraud. You request verification that members closed their accounts, as the credit union's records reflect.

You will verify closed accounts at least with the regular verification of members' accounts. We strongly recommend that you complete the verification on a more timely basis, such as quarterly. Usually, you mail a letter to closed account holders requesting that they verify that they did close the account.

- *Chapter 24* describes the verification of closed accounts.
-

How do we ensure that the board of directors is safeguarding assets, and that management complies with its policies and plans?

4.05 It is not your responsibility to make operating decisions. However, you must ensure that the board's plans and policies are reasonable, and that they protect the safety and soundness of the credit union.

To determine what the board's plans are, you should:

- Attend monthly board meetings or review board minutes.
- Review the business plan for reasonableness.

To ensure that operations are adequately controlled, you should:

- Review the board's policies (Do they provide the structure for adequate control?)
- Ensure that management is implementing these policies.

The examiner may identify material problems with board plans and operating policies during the examination. You may want to use the examination report as a resource to help with identifying and improving any weaknesses in these areas. The examiner will probably suggest additional steps that you need to take to assure that the board and management take corrective action for material problems. Your audit report should also document material deficiencies in policies. Follow the procedures outlined below under "*How do we follow-up on examinations and audits?*".

If you believe that the board's actions, imminent actions, or lack of control will have a material negative impact on the credit union,

you should exercise your authority to take action (as outlined in *Chapter 2* of this guide). You should contact your examiner, the NCUA regional office, or your state supervisory authority prior to taking significant action.

What are internal controls and how do we review them?

4.06 Internal controls include the staff structure, operating procedures, and other measures within the credit union to:

- Safeguard assets.
- Check the accuracy and reliability of accounting data.
- Promote efficiency.
- Encourage compliance with board policies.

Internal controls minimize the possibility that errors or fraud remain undetected for any length of time. Internal controls can also help prevent errors.

Examples. An example of an internal control is establishing passwords on the computer system. This control:

- Prevents unauthorized access.
- Helps to identify transactions by the user.

Another example would be the separation of duties between staff with cash disbursement authority. If staff with access to generate a check are different, and separate, from staff authorized to sign the check, you minimize unauthorized disbursements. Collusion between staff would be required to effect an unauthorized disbursement.

Even small credit unions can establish internal controls. Review of internal controls is one of your most important responsibilities. Refer to the internal control section in *Chapter 7* for guidance on how to review internal controls.

How do we manage and structure an internal audit function?

4.07 An internal auditor is generally an employee of the credit union, but could be a consultant to the credit union, who reviews the credit union operations for weak controls and practices, and recommends improvements. Internal auditing could entail merely a part-time employee or consultant, or an entire department. An internal auditor could fulfill any of your responsibilities, as long as you oversee his or her work.

We highly recommend that you use an internal auditor, when feasible. Of course, such a position would be dependent on whether the credit union could afford the expense, and if there is enough work for the employee. An internal auditor could perform some record keeping functions to increase his or her workload (for example, preparing bank and other reconcilements, but he/she could not then audit record keeping functions performed by him/her-self). Alternatively, several credit unions could share an internal auditor to defray expenses. Refer to *Chapter 6* for more information on the internal audit function.

How do we manage and structure an external audit function?

4.08 You manage an external audit function in much the same way as an internal audit function. You decide what the auditors will review, or accept their review recommendations. The auditors can assist in performing some of your functions, such as following up on weaknesses noted during the audit and examination. You could consider quarterly or semi-annual contacts. You should hire external auditors through use of an engagement letter. See *Chapter 5* for additional information on external audit matters.

What should we consider when looking at internal versus external auditing?

4.09 You should consider the pros and cons in an external versus internal audit environment, such as:

- Are there differences in expertise? Depending on the training you provide, external auditors may be more up-to-date on current topics. On the other hand, it may be difficult finding an external auditor with extensive credit union experience.
-

- It may be easier to interview and hire the external auditor (based on a known reputation).
 - An external function could be tailored to the amount of auditing you need. An employee may seek a full-time commitment.
 - Scheduling may be a problem with an external auditor.
 - Contacts would be intense and brief with an external function. Contact would be on-going with an internal auditor.
 - An internal auditor would be more familiar with your individual credit union. This could also lead to a better relationship with other employees.
 - An internal audit function may be less costly than an external function.
-

How do we follow-up on examinations and audits?

4.10 Examinations and audits should present a largely unbiased view of the overall financial condition of the credit union. They identify material as well as minor problems with the accounting processes, controls, plans or policies. Formal examinations and audit reports (including reports of reportable conditions or errors and irregularities) will document any material findings. Obviously, these reports correspond with your objectives, and are a strong resource for your committee.

Examinations. The examination focuses on safety and soundness concerns, as well as overall controls, regulation compliance and record keeping.

Audits. The audit primarily focuses on accuracy of accounting records, and the internal controls related to the accounting records.

You should ensure that management addresses each of the issues listed in all reports promptly. To aid you in this process, we

recommend that you request a report from management that outlines actions taken to correct the problems identified. You need to review management's response to ensure that corrective actions appear reasonable and adequate. If management did not adopt the corrective actions suggested in the audit or examination report, they should have developed an adequate alternative plan. Particularly if you believe that management may not have adequately addressed the problem, you or your representative should review the area for progress. The audit chapters of this guide provide a reference on auditing specific areas.

If your review supports that the problem still exists and you cannot persuade management to take appropriate action, bring your findings to the board of directors for resolution. In addition, you should discuss the situation with your examiner or auditor if a material problem remains unresolved.

What should we expect when meeting with the federal examiner?

4.11 The federal examiner should meet with you during the annual examination, and will:

- Discuss the supervisory committee audit process with you.
 - Let you know of any material findings noted during the examination, and discuss plans to follow-up on these findings (including any audit deficiencies).
 - Discuss closed account verifications and the bi-annual verification of member's accounts (when you completed them) and how you controlled the process.
 - Discuss any other actions of the supervisory committee since the prior examination.
 - Offer the opportunity to ask questions.
-

How do we handle member complaints?

4.12 You play an essential role in reviewing members' complaints. You will want to make certain you handle complaints in an impartial and independent manner to ensure that you treat all members fairly. If a complaint identifies a policy or procedure that needs correction, you will want to follow through to ensure that the board of directors and credit union management implement corrective changes.

Types of Complaints. Although the types of member complaints vary greatly, the following are somewhat representative. Concerns with:

1. Lending policies and procedures.
2. Loan rejections.
3. Annual meetings.
4. Share withdrawals.
5. Dividend rates and terms.
6. Credit union services.

Regardless of the nature of the complaint, you must conduct a full and complete investigation.

Receipt of complaints. A member may complain either directly to you or, as frequently happens, to the National Credit Union Administration (NCUA). NCUA will normally refer the matter to you. It will request that you investigate the complaint and furnish the NCUA regional office with a written report. The regional office then sends the member a final response letter.

Investigation of complaints. Regardless of how the complaint is brought to your attention, it is suggested that you follow these general steps when investigating the complaint (not necessarily in the order given.)

- (a) *Read the complaint letter.* Briefly outline the areas of complaint and questions asked by the complainant.
- (b) *Determine the appropriate type of investigation.*
- (c) *Interview the complainant, if possible. A personal interview with the member is preferable. If you are able to interview the member:*

- Conduct interviews in private.
 - Be careful not to express an opinion as to the probable validity of the complaint.
 - Conduct discussions in a courteous and professional manner. Convey a sincere regard for the member's concerns.
 - Keep an open mind. Some statements made by the member may not be valid, but they do not disprove his/her entire complaint. The member usually knows little of the internal operation of the credit union, or standards of credit worthiness.
 - If the complaint is routine or simply a disagreement, inform the member that they can resolve it directly with credit union staff.
- (d) *Review the complainant's credit union file.*
- (e) *Review pertinent written credit union policies and procedures, and determine their compliance with applicable credit union laws and regulations.*
- (f) *Review pertinent unwritten procedures (i.e., practices observed by the credit union).*
- (g) *Interview appropriate credit union officials and/or employees.*
- (h) *Review several loans, if necessary, to determine the actual practices of the credit union and how they relate to the complaint.*
- (i) *Determine the validity of the complaint.*
- Do not rely on the credit union's manager or employees to do the investigation for the committee. You should obtain all information firsthand, where possible. Try to determine what actually happened, rather than obtaining various versions of what happened.
-

- You should not initiate a joint meeting between the complainant and the credit union officials as a means of resolving disputes or expediting the investigation. This is often counter-productive and may intimidate the complainant. You act as a liaison between members and management when disputes arise.
 - Remember that no one likes to be investigated. Credit union officials and employees will often be defensive and complainants may also be antagonistic. You will need to be very skillful and tactful in obtaining the necessary information without alienating any of the parties involved.
- j) Work with the officials to develop plans to correct any improper, unfair, or discriminatory practices, if applicable, or make appropriate recommendations.*
- k) Have corrective action implemented or obtain agreements from appropriate credit union officials and/or employees they will make corrections within a specified time.*
- l) When applicable, prepare and submit the written report to NCUA's regional office. Write the report in a clear, concise, and factual manner. NCUA will usually send the report to the complainant as part of the regional office's final response to the individual.*
- m) If the complaint was made directly to the committee (and NCUA is thus not involved), prepare and submit a written response to the member.*
- n) You should maintain a file of all complaint resolutions.*

What other procedures should we consider?

4.13 Consider the following additional procedures:

- Concentrate additional review on any areas of weakness identified in the annual audit or examination. Reference the audit chapters for guidance in reviewing these particular
-

areas. The auditor or examiner may request that you complete certain procedures.

- Conduct surprise cash counts (reference *Chapter 8*).
- Reconcile or verify the accuracy of the credit union's bank reconciliation for three concurrent months (reference *Chapter 8*).
- Review all official, employees, and family member's accounts for preferential treatment and unusual activity (reference *Chapter (10)*, fraud section).
- Review a sample of loans for deficiencies in documentation or quality (reference *Chapter 10*).
- Call a sample of members with new loans to ensure that the loans are legitimate, representing the call as an informal survey (reference *Chapter 10*).
- Trace a sample of new members to ensure that they are eligible for membership.
- Review internal control reports (for example, supervisor override reports, nonamortizing loan reports, etc.).
- Ensure that all employees take at least one week of continuous vacation.
- Help the auditor with the annual audit, if requested (this may reduce the audit fee).

Are there any other resources we can use?

4.14 There are a number of resources for you to use, in addition to this *Guide*. They include your credit union league, your auditor, your federal examiner, and the *Accounting Manual for Federal Credit Unions*. The appendix to this *Guide* also lists other references. Management should be able to help you access these resources.

**Which records
can we access?**

4.15 You have access to all of the credit union's records, without exception. Of course, you are responsible for maintaining strict confidentiality. You shouldn't remove credit union records from the credit union.

**What do we need
to document?**

4.16 You should document all of your reviews to support your work. The federal examiner will request to review your work.

**What if we find
problems?**

4.17 You should document and report all problems to management for correction. You should also provide the board of directors with your report. Reference *Chapter 20* in the Guide, "*How do we report results to the board of directors?*".

Follow the same procedures listed under the "How do we follow-up on examinations and audits?" section above for ongoing follow-up on material problems.

**How do we
coordinate our
plans into a
program?**

4.18 We recommend that you develop an annual work program. We have included a sample program in the appendix to this chapter. Of course, you will need to customize the program to your credit union to focus on the credit union's weaknesses.

SAMPLE SUPERVISORY COMMITTEE WORK PLAN

Note that several of your responsibilities depend largely on outside factors. For example, primary follow-up on audits and exams, meeting with the federal examiner, and member complaints will be handled on a flow basis.

You should review the board's business plan as soon as it is finalized. This example assumes that the board works on the plan in the fall and finalizes the plan in October.

If your credit union has an internal auditor, you should maintain contact with the auditor at least on a quarterly basis.

January

- Complete the verification of member's accounts, including closed account verifications.
- Review personnel records to ensure that all employees took at least one week of continuous vacation last year.
- If you do not plan to complete the audit, contact outside accountants to request bids for the annual audit.
- Attend the monthly board meeting (Chairman, at a minimum).
- Follow-up on prior audit and examination findings if necessary.

February

- Attend the monthly board meeting (Chairman, at a minimum).
 - Review the bank reconciliation. Ensure that adjusting entries are valid and not carried forward.
 - Review employee, official, and related family member accounts.
 - If applicable, review bids from outside accountants, and select accountant.
 - Follow-up on prior audit and examination findings if necessary.
-

March

- Attend the monthly board meeting (Chairman, at a minimum).
 - Conduct a surprise cash, traveler's check, and money order count (schedule for different days during the month).
 - Follow-up on prior audit and examination findings if necessary.
-

April

- Attend the monthly board meeting (Chairman, at a minimum).
 - Conduct the annual audit. Maintain contact with the outside accountant, if one is used.
 - Verify closed accounts.
 - Follow-up on prior audit and examination findings if necessary.
-

May

- Review internal controls in the cash area.
 - Call a sample of members with new loans to ensure that loans are legitimate.
 - Attend the monthly board meeting (Chairman, at a minimum). Provide audit report to the board.
 - Follow-up on prior audit and examination findings if necessary.
-

June

- Request a response from management on any audit findings.
 - Attend the monthly board meeting (Chairman, at a minimum).
 - Conduct a surprise cash, traveler's check, and money order count (schedule for different days during the month).
-

July

- Verify closed accounts.
 - Follow-up on prior audit and examination findings if necessary.
 - Review and follow-up on management's audit response.
 - Review internal controls in the lending area.
 - Review official, employee, and related family accounts.
 - Attend the monthly board meeting (Chairman at a minimum).
 - Follow-up on prior audit and examination findings if necessary.
-

August

- Attend the monthly board meeting (Chairman, at a minimum).
 - Review the bank reconciliation. Ensure that adjusting entries are valid and not carried forward.
 - Call a sample of new members to ensure that they are eligible for membership.
 - Follow-up on prior audit and examination findings if necessary.
-

September

- Conduct a surprise cash, traveler's check, and money order count (schedule for different days during the month).
 - Attend the monthly board meeting (Chairman, at a minimum).
 - Follow-up on prior audit and examination findings if necessary.
-

October

- Review internal controls in the investments area.
 - Review official, employee, and related family accounts.
 - Verify closed accounts.
 - Attend the monthly board meeting (Chairman a minimum).
 - Follow-up on prior audit and examination findings if necessary.
 - Ensure the credit union's operating budget for next year includes funding for external auditing, if applicable.
-

November

- Review the board's business plan.
 - Attend the monthly board meeting (Chairman, at a minimum).
 - Follow-up on prior audit and examination findings if necessary.
-

December

- Attend the monthly board meeting (Chairman, at a minimum).
 - Conduct a surprise cash, traveler's check, and money order count (schedule for different days during the month).
 - Follow-up on prior audit and examination findings if necessary.
-

Chapter 5 -- WHO MUST DO THE AUDIT?

- 5.01 Who may do an audit or verification?**
- 5.02 What types of audit services satisfy the annual supervisory committee audit requirement?**
- 5.03 What must an audit involve?**
- 5.04 Who hires the auditor?**
- 5.05 What is the purpose of an engagement letter?**
- 5.06 Who signs the engagement letter?**
- 5.07 What is required in the engagement letter?**
- 5.08 What should be included in an engagement letter of a supervisory committee audit which does not address all of the required procedures?**
- 5.09 Who receives the written report from the compensated auditor?**
- 5.10 Who is responsible to ensure that the independent, compensated auditor and the auditor's reports comply with the terms of the engagement letter?**
- 5.11 Who prepares the audit report if the supervisory committee or uncompensated representative completes the audit?**
- 5.12 Who has access to the written supervisory committee audit report?**
- 5.13 Who is responsible for reviewing compliance with the Bank Secrecy Act?**

Appendix

5A *Sample engagement letter.*

Who may do an audit or verification?

5.01 The answer to this question depends on the credit union's asset size and source of charter, and falls into one of three categories of auditors:

- (a) An independent accountant licensed by the state or jurisdiction in which the audit is conducted.
 - (b) An independent, compensated qualified credit union auditor.
 - (c) You, your internal auditor, or your designated, uncompensated representative.
-

NOTE: *This Guide is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the Federal Credit Union Act and the NCUA Rules and Regulations §715.*

A compensated auditor means any accounting/auditing professional, excluding credit union employees, who is compensated for performing more than one compensated supervisory committee audit and/or verification of member's accounts, or opinion audit, per calendar year.

An uncompensated auditor, for these purposes, means someone who doesn't perform more than one supervisory committee audit and/or verification for remuneration per calendar year, even though the auditor may be paid for the one audit he/she does perform. The representative may or may not be a professional accountant or auditor.

What types of audit services satisfy the annual supervisory committee audit requirement?

5.02 You may use the following types of audit services to satisfy the requirements of the supervisory committee audit requirements. (Refer to R&Rs §§ 715.2 and 715.7)

- (a) If your credit union is federally insured with assets of \$500 million or more, the work must be performed by an independent accountant licensed by the state or jurisdiction in which the audit is conducted. He or she must perform an opinion audit of the credit union's financial statements.
 - (b) If your credit union is federally chartered with assets of more than \$10 million but less than \$500 million, you have four options:
 - i) As a) above.
 - ii) An opinion audit on the credit union's balance sheet performed by an independent accountant licensed by the state or jurisdiction in which the audit is conducted.
 - iii) An examination of internal controls over call reporting conducted by an independent accountant licensed by the state or jurisdiction in which the audit is conducted.
 - iv) A supervisory committee audit which meets the minimum requirements of this Guide.
-

-
- (c) Federally insured credit unions under \$10 million in assets may very likely choose to perform a supervisory committee Guide audit due to resource constraints.
-

What must an audit involve?

5.03 For a supervisory committee Guide audit, you or your representative must:

- a) Follow the Appendix 4A prescribed supervisory committee work plan or comparable plan of your own development.
- b) Annually complete all relevant internal control checklists/work papers included in this Guide or comparable work papers applying reasonable judgment as needed.
- c) Annually complete all relevant work papers included in this Guide or comparable work papers, performing specific audit steps as required and applying reasonable judgment as needed.
- d) Complete the bi-annual verification of members accounts consistent with Chapter 24.
- e) Perform other duties as necessary: resolve members complaints; follow-up on findings and recommendations in previous examination and audit reports ensuring management action/resolution; etc.

Additional work may be necessary, based on your findings and judgment. This additional work may not be outlined in the Guide and you may need to consider outside sources.

Who hires the auditor?

5.04 You (the supervisory committee) must hire the auditor for the engagement. The board, however, must authorize the budget and approve the expense.

In doing so, you may wish to:

- Ask other credit unions and trade associations for references.
- Obtain competitive bids from auditors with credit union experience.
- Ask the auditor or auditing firm representative relevant questions.

You should inquire about:

- The experience level of the individuals who will complete the audit and their or the firm's knowledge of credit union operations and regulations.
- Professional certification of the individuals who will complete or supervise the audit.
- The time period of the year for scheduling the audit (specifically the time periods where price would be advantageous).
- The individual's or firm's audit program.
- The time frame for receiving the final audit report and related reports of reportable conditions or errors and irregularities.
- Meeting with the in-charge auditor at the end of the engagement.

You must obtain an engagement letter which complies with §715 of the NCUA Rules and Regulations. Refer to *Appendix 5A* for a sample letter.

What is the purpose of an engagement letter?

5.05 The purpose of the engagement letter is to facilitate communication at the contracting point. It also documents "who agreed to do what," and provides the credit union with an enforceable contract. The engagement of an independent, compensated auditor to perform all or a portion of a supervisory committee audit shall be evidenced by an engagement letter.

Who signs the engagement letter?

5.06 The compensated auditor signs the engagement letter. The signed engagement letter is acknowledged by you (the supervisory committee) prior to the start of the audit.

What is required in the engagement letter?

5.07 You must ensure the following items are included:

- Specify the terms, conditions, and objectives of the engagement.
- Identify the basis of accounting to be used (examples, generally accepted accounting principles (GAAP) vs. regulatory accounting practices (RAP)).
- For non opinion audits, include an appendix setting forth the procedures to be performed.
- Specify the rate of, or total, compensation to be paid for the audit.
- Upon completion of the engagement, the auditor will deliver a written audit report to the supervisory committee.
- Notice in writing, either within the audit report or a separate report, of any internal control reportable conditions and/or irregularities or illegal acts which come to the auditor's attention during the normal course of the audit.
- Specify a target date of delivery of the written reports.

- Certify that NCUA staff or its designated representative will be provided unconditional access to the complete set of original working papers either at the credit union or at a mutually agreeable location for purposes of inspection.
 - Acknowledge that working papers shall be retained for a minimum of three years from the date of the written audit report.
-

What should be included in an engagement letter of a supervisory committee audit which does not address all of the required procedures?

5.08 You must ensure the engagement letter:

- Generally identifies the excluded items, if any.
 - States that, because of the exclusion(s), the resulting audit will not, by itself, fulfill the scope of a supervisory committee audit.
 - Includes a caution that the supervisory committee will remain responsible for fulfilling the scope of a supervisory committee audit with respect to the excluded items.
-

Who receives the written report from the compensated auditor?

5.09 You, the supervisory committee, must receive the written audit report.

Who is responsible to ensure that the independent, compensated auditor and the auditor's reports comply with the terms of engagement letter?

5.10 You, the supervisory committee, are responsible. You must meet with the independent compensated auditor at the end of the audit to determine if the auditor complied with the terms of the engagement letter.

Who prepares the audit report if the supervisory committee or uncompensated representative completes the audit?

5.11 In this case, you, the supervisory committee, must prepare the written report of the supervisory committee audit. Refer to the reporting chapter in this Guide.

Who has access to the written supervisory committee audit report?

5.12 You, the supervisory committee, must provide the report(s) to the board of directors.

You must, upon request, provide to the National Credit Union Administration, a copy of each of the written reports received from the auditor.

You must provide a summary of the results to members of the credit union at the next annual membership meeting.

Who is responsible for reviewing compliance with the Bank Secrecy Act?

5.13 You may include the review of compliance with the Bank Secrecy Act in the engagement letter with the auditor. The Bank Secrecy Act is designed to detect the incidence of money laundering and to provide a paper trail of activities. §748.2 of the NCUA Rules and Regulations requires independent testing for compliance by credit union personnel or outside parties.

ILLUSTRATIVE ENGAGEMENT LETTER

(adopted, with modifications, from AICPA industry guide, "Audits of Credit Unions")

***Services Other Than Financial Statement Opinion Audits
Performed by Licensed Individuals***

Supervisory Committee
XYZ Credit Union

[Date]

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide to XYZ Credit Union for the period ending [date].

We will apply certain procedures to selected records and transactions for the purpose of helping you to complete your supervisory committee audit.

The procedures to be performed are summarized in the supplement to this letter. Because those procedures will not constitute an audit made in accordance with generally accepted auditing standards, we will not express an opinion on any of the items specified in the supplement or on the financial statements of the credit union taken as a whole. The scope of this audit as outlined in the supplement does not include an evaluation of all areas that generally are of higher risk in the credit union industry, such as *[securities held or the collectibility of loans, the adequacy of collateral thereon, or the reasonableness of the allowance for loan losses]*. We caution you that you remain responsible for completing the audit work necessary to meet regulatory requirements in these areas excluded from our audit scope.

Our engagement will not include a detailed examination of all transactions and cannot be relied on to disclose errors, irregularities, or illegal acts, including fraud or defalcations, that may exist. However, we will inform you of any such matters that come to our attention.

We direct your attention to the fact that management has the responsibility for the proper recording of the transactions in the accounting records and for preparation of financial statements in conformity with generally accepted accounting principles.

Certain of the procedures described in the supplement to this letter will be applied on a surprise basis during the year after we consult with the appropriate regulatory agencies to ensure that the date selected will not conflict with their examinations.

Our report will include a summary of the accounts and elements subject to our audit and the procedures performed.

This report will be issued solely for the information of the credit union's supervisory committee and management and appropriate regulatory agencies *[or other specified third parties]*; it is not to be used by any other parties because of the restricted nature of our work. Our report will

also contain a paragraph indicating that had we performed additional procedures or had we made an audit of the financial statements in accordance with generally accepted auditing standards, other matters might have come to our attention that would have been reported to you.

Our fees are based on the time required by the individuals assigned to the engagement, plus direct expenses. Individual hourly rates vary according to the degree of responsibility involved and the skill required. Interim billings will be submitted as services are rendered and as expenses are incurred.

We will be pleased to discuss this letter with you at any time. If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Sincerely yours,

[Signature of Independent Auditor]

Acknowledged:

[Name of Credit]

[Signature of Supervisory Committee Chairman]

[Date]

Chapter 6 -- SHOULD WE HAVE AN INTERNAL AUDIT FUNCTION?

- 6.01 Who should have an internal auditor?**
- 6.02 How can an internal audit function assist us?**
- 6.03 What are our responsibilities with regard to the internal audit function?**
- 6.04 What are the board of directors' responsibilities?**
- 6.05 How do we go about hiring an internal auditor?**
- 6.06 What qualifications should our internal auditor have?**
- 6.07 What is the audit plan and what should it include?**
- 6.08 What reports should the internal auditor prepare for us and to whom should we deliver them?**

Who should have an internal auditor?	6.01 All large credit unions with complex operations should give serious consideration to having an internal audit department. Other credit unions are urged to have internal audit functions. The benefits gained from the recommendations stemming from internal audits can be invaluable to the credit union's operations.
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How can an internal audit function assist us?	6.02 The internal audit function can assist you in: <ul style="list-style-type: none">• Ensuring accurate and reliable information is produced by the credit union.• Determining the effectiveness of the internal control structure.• Promoting operational efficiencies.• Safeguarding assets of the credit union.
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NOTE: *This Guide is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the Federal Credit Union Act and the NCUA Rules and Regulations §715.*

- Encouraging compliance with internal policies and procedures as well as external laws and regulations.

An internal audit can be:

- An integral part of the evaluation of internal controls.
- A check and balance on management functions.
- An effective measure for the prevention and detection of loss.

An extremely useful and valuable function of internal auditors is to aid, assist, and help coordinate the work of regulators and external auditors. When an internal auditor is permitted to act with the necessary degree of independence, reliance on his/her work can reduce the amount of time and expense outside parties must commit to the review and analysis of the credit union. See more discussion of independence in *paragraph 6.06*.

The role of the internal auditor must move beyond just assessing internal controls and safeguarding assets. As the credit union industry becomes more technologically advanced, changes in the day-to-day operations can become overwhelming. The internal audit function must keep pace with changes and innovations. Internal auditors can provide invaluable analysis and support for new or proposed business plans or strategies.

And finally, the supervisory committee may choose to use the internal auditor to perform the Supervisory Committee Guide audit under § 715.7(c). Note, however, that the employment of an internal auditor does not replace the supervisory committee or its function.

What are our responsibilities with regard to the internal audit

6.03 You, the supervisory committee, play a key role in the internal audit function. **It is best if the internal auditor reports directly to you**, and as such, it is your responsibility to routinely make yourselves available to the internal auditor. You should aid

function?

in the development of the audit program and should establish a monitoring and follow-up procedure to measure the internal auditor's performance and effectiveness. A key role you must play is in acting as a conduit between the internal auditor and the board of directors and management staff. You must be instrumental in facilitating these communications.

What are the board of directors' responsibilities with regard to the internal audit function?

6.04 The board of directors must establish a corporate environment which allows the internal auditor to perform his duties freely and without restriction. The board should ensure sufficient resources are allocated to the internal audit function in order for it to conform to the standards of internal auditing. The board must require management to respond to audit reports and to take necessary and appropriate corrective action(s).

How do we go about hiring an internal auditor?

6.05 There are several methods of employing an internal auditor. There are national, regional, and local organizations of internal auditors which may serve as resources for finding appropriate internal audit employees.

Smaller credit unions with limited resources may want to consider sharing an internal auditor with other small credit unions on a consulting basis. Under these arrangements, you generally contract for a quantity of hours of the internal auditor's time.

It is important that you hire a qualified individual to carry out this critical responsibility.

What qualifications should our internal auditor have?

6.06 Your internal auditor's qualifications should be commensurate with the size and complexity of your credit union. All internal auditors should possess:

- Academic credentials and/or technical training and proficiency.
- A commitment to continuing education and professional development.
- Well-developed written and oral communication skills.
- Independence.

Continuing Professional Development. Your internal auditor’s continuing education is vital for ensuring efficient and effective audits with recommendations that enhance the overall operations of the credit union.

Independence. Independence is defined as “freedom from the influence, guidance, or control of another or others.” An internal auditor’s independence is vital to achieving reasonable assurance that internal controls are functioning properly, will safeguard the assets of the credit union and prevent and detect errors and irregularities.

One measure of an internal auditor’s independence is the auditor’s location within the organizational structure of the credit union. The internal auditor should report directly to you, the supervisory committee. The organizational status of the internal auditor speaks to objectivity. It is important to note the only way the internal audit function can operate effectively and add value to the credit union (in meeting regulatory audit and verification requirements) is by ensuring the reporting relationship is at a very high level.

What is the audit plan and what should it include?

6.07 A sample supervisory committee workplan has been provided in Chapter 4, Appendix 4A.

The internal auditor’s audit plan should generally be the work anticipated to be completed within the next year. However, the

frequency of an audit of certain operational areas or functions should be based on the attendant risk factors. The plan should have a degree of flexibility to allow for audits of the adequacy of controls within new systems and/or significant changes to existing systems. An evaluation by the internal auditor should be part of contemplated changes and modifications to systems and functions.

When determining the scope of work, the internal auditor must consider: (a) size and scope of the operation or function relative to the size and complexity of the credit union; (b) the existence of appropriate written policies and procedures; and (c) the effect potential losses would have on the financial condition of the credit union.

What reports should the internal auditor prepare for us and to whom do we deliver them?

6.08 Formal reports should pinpoint the areas of weakness and contain clear, concise recommendations for corrective actions. These reports should be delivered to you, the supervisory committee. You should then provide them to the board and management staff having the responsibility for implementing corrective actions. You should follow-up on recommendations to ensure timely and effective implementation.

Your internal auditor must document the work performed. The workpapers should detail audit programs and analyses that clearly reflect the procedures completed, the extent of testing, and the reported results.

At least once each year, the internal auditor should prepare a summary report of all audit activities for you. You should share this information with the board of directors and senior management. The report should include summaries of recommended actions and responses to the recommendations by the appropriate staff. The report should express an opinion of the overall condition of the controls and operations.

Chapter 7 -- WHAT STEPS MUST WE TAKE TO COMPLETE THE AUDIT OURSELVES?

- 7.01 What is involved in doing the audit ourselves?**
- 7.02 Why are sound internal controls important?**
- 7.03 How do we learn about the credit union's internal control structure?**
- 7.04 Could you discuss further the three elements of an internal control structure?**
- 7.05 What is involved in planning the audit?**
- 7.06 What is materiality?**
- 7.07 What should be our focus when reviewing internal controls?**
- 7.08 What audit testing is necessary and most effective?**
- 7.09 What should be the focus of our testing?**
- 7.10 What additional audit tests may be necessary?**
 - 7.11 For cash?**
 - 7.12 For investments?**
 - 7.13 For loans?**
 - 7.14 For shares?**
- 7.15 How do we review related party transactions?**
- 7.16 What reports should we review as part of the audit if the credit union has an EDP system?**
- 7.17 What are the considerations in audit planning for manual credit unions?**
- 7.18 What are some of the main audit concerns with manual credit unions?**
- 7.19 What other issues must we review in the audit stage?**

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- | | |
|---|--|
| What is involved in doing the audit ourselves? | 7.01 You must: <ul style="list-style-type: none">• Complete Guide working papers (or comparable worksteps) dealing with the credit union's system of internal controls. |
|---|--|
-

NOTE: *This Guide is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the Federal Credit Union Act and the NCUA Rules and Regulations §715.*

- Develop a credit union specific audit program using Guide working papers (or comparable worksteps) adjusted to your credit union's needs.

You must plan your audit tailored to your credit union's specific needs and complexity.

Why are sound internal controls important?

7.02 Internal controls comprise the plans of organization and operating procedures and measures within the credit union to safeguard assets, check the accuracy and reliability of accounting data, promote operational efficiency, and encourage adherence to the prescribed managerial policies. Such plans and procedures need to be in writing.

Section 113 of the Federal Credit Union Act states that the board of directors shall have the general direction and control of the affairs of the credit union. The board is responsible for the proper and profitable conduct of credit union operations, the safety of credit union assets, and the accuracy of financial statements. The directors themselves cannot normally perform the work resulting from these responsibilities, so they retain employees to act for them. However, since the board of directors still retains overall responsibility for the affairs of the credit union, they must establish internal controls for the operation of the credit union.

It is important that you understand the internal control structure functioning within your credit union. If your credit union is small, it may be difficult to achieve the segregation of duties critical to an effective internal control system and therefore, more directed audit testing may be advisable.

How do we learn about the credit union's internal control structure?

7.03 An internal control structure should include three elements:

- The control environment.
- The accounting system.
- The control procedures.

You must become familiar with each element.

Could you discuss further the three elements of an internal control structure?

7.04 The control environment takes into consideration:

- Management policies and plans.
- Organizational structure.
- Involvement of officials (board and committee).
- Assignment of authority and responsibility.
- Personnel policies.
- Examinations.

The accounting system takes into consideration:

- The quality of the books and record keeping system.
- The maintenance of accounting records.
- The financial reporting system.
- The preparation of accurate financial statements.

The control procedures take into consideration:

- Appropriate authorization of transactions.
 - Sound segregation of duties.
 - Safeguarding of credit union assets -- particularly cash, investments, and fixed assets.
 - Security access level and controls over the EDP system.
-

- Management or supervisory committee periodic reviews and test checks.
-

What is involved in planning the audit?

7.05 Audit planning is a very important part of the audit, since you determine the scope of the audit in the planning stage. An important factor in planning is the *qualifications of the individuals who will perform the audit*. To adequately plan the audit, you must have experience with and knowledge of the *credit union products and services*. See Chapter 3 of this *Guide* for additional guidance on qualifications of the person(s) performing the audit.

Specific materials to use in audit planning:

- Recent statement of financial condition and income statement. Recent NCUA Financial Performance Report.
 - Recent NCUA Supervisory Examination Report.
 - Credit union charter and bylaws.
 - Credit union policies.
 - Board meeting minutes.
 - Roster of employees and officials.
 - NCUA Rules and Regulations (emphasis on recent changes and new Regulations).
 - Last year's audit report and working papers.
 - Surety bond company risk management audit report.
 - Loan, cash, investment, and share internal control check lists.
-

Specific items to consider in audit planning:

- Local economic trends.
 - Stability of the sponsor or field of membership.
 - Personnel changes.
 - Materiality level (see later section of this chapter).
 - Type of Electronic Data Processing (EDP) system and controls.
-

What is materiality?

7.06 Materiality is a very subjective concept. It is defined in section 2000 of the *NCUA Accounting Manual*.

A statement, fact or item is material if, giving full consideration to the surrounding circumstances as they exist at the time, it is of such a nature that its disclosure, or the method of treating it, would be likely to influence or to make a difference in the judgment and conduct of a reasonable person. The accumulation of many small items, each of which in itself wouldn't be material, would be material if the overall effect would tend to influence the judgment and conduct of a reasonable person.

Materiality is influenced by total assets, total capital and profitability.

A benchmark you might choose for determining materiality could be one half of one percent of total assets, (for credit unions with satisfactory capital and profitability). This level is most likely a lower materiality threshold than many CPAs would choose if performing an opinion audit for credit unions.

What should be our focus when reviewing internal controls?

7.07 You evaluate the effectiveness of the internal control structure policies and procedures in preventing or detecting material misstatements in the financial statements.

We provide sample internal control check lists in this *Guide* for each of the main elements of the credit union financial statement. We designed these check lists to provide a basis for understanding the credit union's internal control structure. You identify an internal control weakness by reviewing the internal control questions with a "no" response.

Some of the factors which may be problematic include:

- One or two people do the work due to limited staff size.
 - Lack of board approved policies for lending, investments, borrowing, and operating expenses.
 - Lack of segregation of duties (no dual controls for key areas such as cash, loans, investments and shares).
 - Lack of mandatory vacation policy for all employees.
 - Failure to maintain adequate audit trails.
 - Record keeping problems (accounting and financial statements are behind, not reconciled, or materially out-of-balance).
 - High level of operating expenses.
 - Poor loan quality.
-

What audit testing is necessary and most effective?

7.08 The two categories of audit tests generally are:

- a) Tests of balances.
- b) Analytical procedures.

According to the *AICPA Credit Union Audit Manual*:

“Tests of balances are procedures applied to the individual items that compose an account balance or class of transactions. The tests involve confirmation, inspection, or observation procedures to provide evidence about the recorded amount.”

“Analytical procedures are tests applied to the total recorded amounts and are based on the existence of plausible and consistent relationships among financial statement elements or between financial and non-financial amounts.”

Tests of balances provide stronger evidence and are more effective. We recommend tests of balances for gathering satisfactory audit evidence.

What should be the focus of our testing?

7.09 You should perform tests to determine whether:

- Assets or liabilities of the credit union exist at a given date and whether recorded transactions have occurred during a given period.
 - All transactions and accounts that should be presented in the financial statements are so included.
 - Asset, liability, income and expense components have been included in the financial statements at appropriate amounts.
-

- Assets are the rights of the credit union and liabilities are the obligations of the credit union at a given date.
 - Particular components of the financial statements are properly classified, described and disclosed.
-

What additional audit tests may be necessary?

7.10 Based on your review of the internal control structure, competency of management, and complexity and size of your credit union, you should determine what additional tests may be necessary. Examples of increased audit testing are provided below for various audit areas: cash, investments, shares, etc.

7.11 For Cash? Cash on Hand. You complete more than one cash count as part of the audit. You complete random, surprise cash counts of teller cash and vault cash.

Cash Items. You complete more than one travelers checks count as part of the audit.

You confirm the balance of travelers checks with the travelers checks company more often.

Cash in Bank. You review/test more than one month of bank account reconcilements. For example review two or three non-consecutive month-end bank reconcilements. You expand the testing period for the receipts with deposits tests. For example, test two months of general ledger account activity.

7.12 For Investments? You:

- Perform a detailed review of the investment portfolio.
 - Review all investments outstanding as of the audit date, (Trace to statements or safekeeping receipts).
 - Review a random selection of investment purchase and redemption transactions during the audit period for proper accounting treatment.
-

- Confirm investment accounts more than one time during the audit period.

7.13 For Loans? You:

- Expand the sample size of your loan review.
- Test the delinquency status for a larger portion of the loan portfolio.
- Review month-end loan account general ledger balancing procedures for more than one month-end date. For example, compare the General Ledger loan total to the total of all loan trial balances for three non-consecutive month-end dates.
- Increase the scope of your review of loan computer file maintenance (loan data change) reports.
- Review the extent and appropriateness of any extension agreements used.

7.14 For Shares? You:

- Review month-end share account general ledger balancing procedures for more than one month-end. For example, review balancing information for three month-end dates.
 - Review negative share account reports for several other dates (e.g., mid-month and month-end) other than just the most recent or audit date report.
 - Be alert for large volume (both number of transactions and dollars) for individual accounts.
 - Review the accounting for returned NSF share drafts and NSF ATM transactions, if applicable.
 - Review month-end dormant (inactive) share account reports for several month-end dates.
-

- Review a sample of transactions on dormant accounts. (Determine if dual control was necessary to authorize a transaction on a dormant share account.)
-

How do we review related party transactions?

7.15 Related Party Transactions. The review of related party transactions, (in the most basic approach) involves the review of employee's and official's loan and share accounts. You:

- Review loans to determine compliance with credit union policy.
- Review loan interest rates and terms to determine if preferential treatment exists. (Sometimes employees may have different rates).
- Review loan account history and share account history to determine if account activity is proper.
- Conduct further testing of related party transactions by reviewing the loans and share accounts for relatives of employees and officials.

Refer to *Chapter 20* in this *Guide*, "How Do We Audit Related Party Transactions?," for more information.

What reports should we review as part of the audit if the credit union has an EDP system?

7.16 You should review the following reports:

- Negative share reports.
 - Unposted item reports for NSF drafts and NSF ATM transactions.
 - Computer file maintenance (data change) reports -- focusing on loan data changes and address changes.
-

- Loans by interest rate summary -- look for loans with unusually low interest rates.
- Paid ahead loan report -- review the reason the loan is paid ahead more than 60 days.
- Dormant (inactive) share account reports.
- Any exception reports.

The above reports are typically available at the end of each business day or at month-end.

Refer to *Chapter 21* of this *Guide* for more information.

What are the considerations in audit planning for manual credit unions?

7.17 Manual credit unions (non-automated) will require a somewhat different planning approach particularly in regards to audit scope. Since the general ledger records are manual, we recommend the following audit procedures:

- Extend testing/footing of the Journal of Cash Receipts (JCR) for a minimum one month period.
 - Trace summary postings from the JCR to the individual general ledger accounts (e.g., share and loan ledger) for a one month period.
 - Foot the total of member share and loan records for three month-end periods.
 - Select a sample of new loans from the manual loan officer/credit committee minutes and trace the loan information from the loan notes back to the minutes (10).
 - Review a sample of loan records for proper allocation of principle and interest (5).
-

- Review a sample of loan records for proper delinquency calculation.
 - Review a sample of share records for proper dividend calculations (5).
 - Foot the general ledger trial balance of accounts for the month-end audit date to ensure that balances are correct for balance sheet and income statement account categories.
 - Trace the accounts on the general ledger trial balance to the credit union's financial statements to verify correctness.
-

What are some of the main audit concerns with manual credit unions?

7.18 The audit should include testing of the following areas:

- Accurate loan delinquency reporting.
 - Correct footing of the loan and share records.
 - Correct calculation of loan principle and interest when payments are received.
 - Correct calculation of share dividends.
-

What other issues must we review in the audit stage?

7.19 You review the following areas for compliance:

- Record preservation policy, §749 of the NCUA Rules and Regulations (Rules and Regulations);
 - Security program policy, §748.0 of the NCUA Rules and Regulations;
 - Bank Secrecy Act compliance program and procedures, §748.2 of the NCUA Rules and Regulations;
-

- Fidelity bond and insurance coverage, §701.20 of the NCUA Rules & Regulations;
 - Investments in and Loans to Credit Union Service Organizations, §712 of the NCUA Rules and Regulations and,
 - FCU ownership of Fixed Assets, §701.36 of the NCUA Rules & Regulations.
-

Chapter 8 -- HOW DO WE AUDIT CASH?

- 8.01** What general ledger accounts are part of the cash area?
- 8.02** What off balance sheet cash items need to be audited?
- 8.03** What are the general objectives in auditing cash?
- 8.04** How do we learn about internal controls over cash?
- 8.05** How do we audit cash in the bank?
- 8.06** How do we audit the change fund?
- 8.07** How do we audit petty cash?
- 8.08** How do we audit wire transfers?
- 8.09** How do we audit travelers checks?
- 8.10** How do we audit money orders?

Appendices

- 8A** *Internal Control Checklists.*
- 8B** *Cash-in-bank Account Reconciliation Form.*
- 8C** *Receipts To Deposit Test Form.*
- 8D** *Sample Confirmation Letter For Cash-in-bank Accounts.*
- 8E** *Cash Count Sheet.*
- 8F** *Change Fund Recap Form.*
- 8G** *Travelers Check Inventory Form.*
- 8H** *Sample Confirmation Letter For Travelers Checks.*

What general ledger accounts are part of the cash area?

8.01 The accounts identified in the *Accounting Manual for Federal Credit Unions* as the 730 series of general ledger accounts usually identify the cash-classified accounts.

Cash accounts include:

- Cash-in-bank (savings and checking accounts).
- Change fund accounts (cash on hand).
- Petty cash.

In some instances, an “in-house” draft account is used by the credit

NOTE: *This Guide is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the Federal Credit Union Act and the National Credit Union Administration Rules and Regulations §715.*

union as a checking account. In-house draft accounts are part of the scope of the cash area. Credit unions which own ATM machines may also have separate general ledger accounts for ATM change fund. Change fund is the term used for teller and vault cash on hand.

Wire transfer policies and procedures are also important. Wire transfers are the fastest and easiest way for cash to leave the credit union. A large sum of cash may be transferred via a wire transfer. Wire transfers are initiated by a telephone transaction or by computer terminals which have the capability, such as a fedwire terminal.

To assist you in reviewing the cash area, work papers, sample confirmation forms, and instructions are included at the end of this chapter.

What off balance sheet cash items need to be audited?

8.02 If the credit union offers travelers checks and money orders, you must review these items. Travelers checks and money orders are usually on consignment with an outside company and are easily converted to cash. See Appendices 8G and 8H for sample workpapers.

What are the general objectives in auditing cash?

8.03 You want to assess whether or not cash:

- Exists and is a credit union asset.
- Balances are complete and accurate.
- Transactions have been properly recorded and all reconciling items identified for the period under audit.
- Restricted cash (limited as to use) is so identified and labeled.

To do this, you must:

- Review internal controls over cash.
 - Perform tests of controls.
 - Determine the audit testing necessary to meet the above objectives.
-

How do we learn about internal controls over cash?

8.04 Since cash is a liquid asset, internal controls are a very important audit concern. The potential for inappropriate activities and fraud make audit procedures for the cash area a critical part of the annual audit.

One way to review the internal controls is for you to complete the internal control checklists in this guide. Internal control checklists for cash can be found in *Appendix 8A*.

How do we audit cash in the bank?

8.05 See Appendix 8D for sample workpapers. You must:

- Determine if internal controls are adequate.
- Review and test each cash-in-bank account to determine that accounting is proper.
- Review each bank account to determine if the month ending balance of the account, as of the audit date, is accurate.
- Determine if cash-in-bank is properly classified on the statement of financial condition.

In applying audit tests, you should:

- Review the internal control checklist.
 - Complete and mail bank confirmations as of the audit date.
-

- Review bank account reconciliations as of the audit date.
- Foot the bank account reconciliations.
- Trace the bank account balance on the reconciliation to the bank statement.
- Trace the general ledger balance on the reconciliation to the general ledger trial balance.
- Trace all significant reconciling items to supporting documentation (bank statements if applicable).
- Trace the amount reported as a deposit in transit to the following month's bank statement as a deposit.
- Trace the amount reported as a deposit in transit to the general ledger history for the same month of the bank reconciliation.
- Foot the outstanding checks list.
- Trace the outstanding checklist as of the audit date to the following month list of checks cleared on the bank statement.
- Review original checks issued for the month of the audit for unusual transactions, (check copies may be reviewed if the original checks are not returned). A random selection of another one-month period is recommended also.
- Review any inter-bank transfers recorded on the general ledger for the month of the audit period to determine that transfers are correctly accounted for in the proper period.
- Complete a reconciliation of receipts with deposits.

**How do we audit
the change fund?**

8.06 You must:

- Determine if internal controls are adequate.
- Complete an unannounced change fund count and determine if the change fund agrees with the credit union accounting records. See Appendix 8F for sample workpapers.
- Determine if the change fund is properly classified on the statement of financial condition.

In applying audit tests, you should consider procedures to:

- Review the internal control checklist for the change fund.
- Complete a 100 percent change fund count using a cash count sheet for all teller cash, vault cash and ATM cash (if applicable).
- Total the individual cash count sheets and compare to the tellers' proof sheets (credit union balancing information).
- Total all cash count sheets for each applicable general ledger account and compare the amount of cash counted with the effective date of the general ledger balance.
- Review petty cash fund procedures and count petty cash if material.
- Investigate any significant difference between the cash count balance and the general ledger balance.
- Review the statement of financial condition and determine if the change fund is accurately reported.

How do we audit petty cash?

8.07 You must:

- Determine (use your judgment) if the amount in petty cash is material. If material, complete a cash count.
-

- Determine if the account is reconciled at least monthly by employees who otherwise do not have access to the fund or fund records.

If it is deemed important to count the petty cash:

- Complete a cash count of the petty cash funds using a cash count sheet. Refer to the sample cash count sheet included in the Appendix to this chapter.
 - Include the total of paid receipts in the petty cash fund as a line item on the cash count sheet.
 - Total the amount of cash and receipts counted.
 - Compare the total amount counted with the general ledger balance of Petty Cash.
 - Investigate any significant difference between the general ledger balance and the count of petty cash.
-

How do we audit wire transfers?

8.08 You complete the following:

- Review the internal controls for wire transfers. You may use the internal control checklist for wire transfers which is included in this Guide. See Appendix 8A for Internal Control Checklist.
 - Test a sample of material wire transfers recorded during the audit month when auditing activity in the cash-in-bank account. Trace large dollar amount wire-outs, (credits recorded to the general ledger account) to the appropriate cash-in-bank account.
 - Test a sample of wire transfers to review if authorized individuals completed the transfer. Supporting source documentation (such as journal vouchers or a log) should be maintained to document who completed the wire transfers.
-

- Ensure that the individuals who perform the wire transfers aren't allowed to reconcile the bank accounts which are used for wire transfer activity.
-

How do we audit travelers checks?

8.09 You must:

- Determine if internal controls are adequate.
- Complete a count of the travelers checks inventory.
- Determine if the inventory consists of the same dollar amount reported by the travelers checks company.

In applying audit tests, you should:

- Review the internal control checklist.
 - Complete a 100 percent count of the travelers checks inventory.
 - Compare the total amount of the travelers checks inventory with the credit union subsidiary record (which is kept for balancing purposes).
 - Investigate any significant differences when comparing total travelers check counted with the subsidiary record.
 - Confirm the balance of the travelers checks directly with the travelers checks company.
 - Compare the written confirmation received from the travelers checks company with the inventory listing completed on the date of the count.
 - Investigate any significant differences between the written confirmation and the count.
-

How do we audit money orders?

8.10 Money orders are audited by reviewing the general ledger account for Money Orders Payable. This account is usually reported as a liability account on the general ledger. As money orders are sold, the liability account is credited. When funds are transferred to the money order company, the general ledger account is debited to clear the payable account. Funds are usually remitted to the money order company weekly or daily.

You complete the following procedures:

- Determine if internal controls are adequate. A sample internal control checklist is provided in Appendix 8A. You may use this internal control checklist for your review.
 - Review the reconciliation for the Money Orders Payable general ledger account as of the audit date. Determine if the Money Orders Payable general ledger account is properly clearing as funds are remitted to the money order company. The dollar amount of money orders sold/issued must agree with the amount remitted to the money order company for the particular time period involved.
 - Determine if the money order supply is properly secured to prevent unauthorized use. Check to see if the money order supply is kept under lock and key and is under dual control.
 - Determine if copies of money orders are retained for possible future investigation. Copies of money orders issued are usually retained in the individual teller's daily work.
 - If a signature machine is used to issue money orders, determine if the number of money orders issued is reconciled daily. The dollar amount issued should also be reconciled daily by an employee.
-

Appendix 8A -- Internal Control Checklist: Cash

The following checklist is designed to assist you to review internal controls and identify any weaknesses. You may find additional guidance in the “AICPA’s Audits of Credit Unions and/or Credit Union Audit Manual.”

Test	Procedure	Yes	No
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Change fund (cash-on-hand) - Internal Control Checklist.

1. Does each teller have his own cash drawer?	Determine this by inquiry during the cash count.	<input type="checkbox"/>	<input type="checkbox"/>
2. Does each teller have bait money?	Determine this during the cash count.	<input type="checkbox"/>	<input type="checkbox"/>
3. Are spare keys for cash drawers under a system of dual control?	Review internal controls with individuals responsible for the change fund during the cash count. Access to spare keys must be authorized by at least two individuals.	<input type="checkbox"/>	<input type="checkbox"/>
4. Is there a system to identify the transfer of funds from the vault to individual tellers?	Review this with the tellers by inquiry during the cash count.	<input type="checkbox"/>	<input type="checkbox"/>
5. Is a change fund limit in place for the tellers, the vault and a total for each office?	Determine whether a written change fund policy includes limits for the teller and vault change fund.	<input type="checkbox"/>	<input type="checkbox"/>
6. Do teller transaction receipts identify the teller who performed the transaction?	Determine whether transaction receipts include a teller identification number.	<input type="checkbox"/>	<input type="checkbox"/>
7. Is the change fund balanced daily with the general ledger?	Review the change fund records which compare teller and vault end-of-day totals with the general ledger balance. Tellers should balance cash daily.	<input type="checkbox"/>	<input type="checkbox"/>
8. Does a written cash over and short policy exist?	Review with management. The policy should include dollar and frequency limits concerning cash over and short differences. The policy should address disciplinary action.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 8A -- Internal Control Checklist: Cash

Test	Procedure	Yes	No
9. Is a log kept to track the cash over and short records for individual tellers?	Review with management.	<input type="checkbox"/>	<input type="checkbox"/>
10. Does someone complete periodic surprise cash counts?	Determine if the supervisory committee, management employee, internal auditor or outside auditor completes random cash counts monthly or quarterly. Teller, vault and ATM change fund accounts should be in the scope of the surprise cash counts.	<input type="checkbox"/>	<input type="checkbox"/>
11. Do adequate safekeeping facilities exist for cash?	Ensure the amount of cash kept on hand in the safe or vault is adequate relative to the credit unions operational needs. Additional guidance is available from the surety bond company.	<input type="checkbox"/>	<input type="checkbox"/>
12. Are tellers prohibited from processing their own and related party transactions?	Tellers should not process transactions on their own accounts. Tellers should not process transactions for relative's accounts. Check to see if the computer system limits employee access to their own accounts and relative's accounts.	<input type="checkbox"/>	<input type="checkbox"/>
13. Are tellers required to deposit checks received at the end of the day?	Check to see if checks received during each day are kept in the end-of-day check deposit. Tellers should not hold over checks into the following day.	<input type="checkbox"/>	<input type="checkbox"/>
14. Are member drafts drawn on the credit union, withdrawn immediately?	Determine if tellers withdraw funds from the accounts immediately for in-house drafts presented.	<input type="checkbox"/>	<input type="checkbox"/>
15. Is management aware of the record keeping and reporting requirements of the Bank Secrecy Act?	Review whether or not compliance with the Bank Secrecy Act and reporting requirements for certain transactions have been reviewed at least annually, as required.	<input type="checkbox"/>	<input type="checkbox"/>
16. Is the ATM change fund balanced with a system of dual control?	Review whether two individuals routinely are involved in the balancing and reconciliation of ATM change fund accounts.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 8A -- Internal Control Checklist: Cash

Test	Procedure	Yes	No
17. Are cash shipment counts under a system of dual control?	Review whether or not two individuals are involved in the count of all cash shipments received to verify any differences immediately.	<input type="checkbox"/>	<input type="checkbox"/>
18. Did the cash count balance with the general ledger?	Compare total cash (change fund) counted with the total reported on the effective day general ledger.	<input type="checkbox"/>	<input type="checkbox"/>
19. Has a maximum change fund amount been approved by the board of directors and is the change fund on hand within this limit?	Verify maximum limit in board meeting minutes or written board policy statement.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 8A -- Internal Control Checklist: Cash

Test	Procedure	Yes	No
Travelers Checks And Money Orders - Internal Control Checklist.			
1. Do adequate safekeeping facilities exist for travelers checks and money orders?	Determine whether access to safekeeping facilities for travelers checks and money orders is limited to as few individuals as possible.	<input type="checkbox"/>	<input type="checkbox"/>
2. Is a log or adequate subsidiary record kept for the travelers checks inventory?	Review the log of travelers checks and money orders. Such a log must include: travelers check serial numbers, denominations, and quantity. The credit union should maintain the inventory in sequential serial number order.	<input type="checkbox"/>	<input type="checkbox"/>
3. Does someone complete a surprise inventory of travelers checks?	Review segregation of duties: usually one or two individuals are responsible for the travelers checks log; someone other than the primary individuals should complete an inventory monthly or quarterly.	<input type="checkbox"/>	<input type="checkbox"/>
4. Is the inventory of travelers checks reasonable in relation to needs?	Review the total inventory in relation to actual sales patterns to determine reasonableness. The travelers check inventory should not be excessive.	<input type="checkbox"/>	<input type="checkbox"/>
5. Is the travelers check settlement general ledger account activity posted and reconciled by an individual who does not have access to the travelers checks?	Review the travelers check settlement account reconciliation procedures noting the importance of proper segregation of duties. This may help to prevent inappropriate activity and unauthorized use of travelers checks.	<input type="checkbox"/>	<input type="checkbox"/>
6. Is the money order settlement general ledger account activity posted and reconciled by an individual who does not have access to the money orders?	Review the money order settlement account reconciliation procedures noting the importance of proper segregation of duties. This may help to prevent inappropriate activity and unauthorized use of money orders.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 8A -- Internal Control Checklist: Cash

Test	Procedure	Yes	No
7. Did the travelers checks count balance with the credit union's log or subsidiary record?	Compare total travelers checks counted with the records maintained by the credit union to track total travelers checks.	<input type="checkbox"/>	<input type="checkbox"/>
8. Did the written confirmation received from the travelers checks company agree with count completed for the audit?	Compare the written confirmation received with the inventory sheet. Investigate any significant difference.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 8A -- Internal Control Checklist: Cash

Test	Procedure	Yes	No
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Cash in Bank - Internal Control Checklist.

1. Are bank deposits prepared by an official or employee who does not serve as a teller?	Check for proper segregation of duties in the preparation of bank deposits by reviewing staff assignments: bank deposit preparation hopefully separate from teller functions.	<input type="checkbox"/>	<input type="checkbox"/>
2. Are bank deposits made intact within the time limits prescribed in the FCU Bylaws?	Ensure deposits are made within proper time limits -- The bylaws require deposits to be made no later than the second banking day after their receipt. Intact deposits refers to all cash and checks received in the period are deposited together.	<input type="checkbox"/>	<input type="checkbox"/>
3. Are all check signers authorized by the board of directors?	Review a current list of all employees and officers authorized to sign checks. Determine whether internal controls prevent check signers from also posting transactions to the general ledger.	<input type="checkbox"/>	<input type="checkbox"/>
4. Are authorized check signers prohibited from signing checks payable to themselves?	Determine if internal controls protect against check signers signing a check payable to themselves. This is recommended for proper segregation of duties.	<input type="checkbox"/>	<input type="checkbox"/>
5. Are all expenses properly approved before payment?	Review a sample of supporting documents.	<input type="checkbox"/>	<input type="checkbox"/>
6. Are invoices and bills marked paid with the date of payment to avoid duplication of payment?	Review a sample of paid bills.	<input type="checkbox"/>	<input type="checkbox"/>
7. Are voided checks properly marked and retained?	Determine whether voided checks are marked to prevent unauthorized use.	<input type="checkbox"/>	<input type="checkbox"/>
8. Are bank reconcilements prepared promptly each month by persons not directly involved in handling cash or the	Recommended for proper segregation of duties.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 8A -- Internal Control Checklist: Cash

Test	Procedure	Yes	No
accounting records?			
9. Does the supervisory committee, internal auditor, or other management employee periodically review bank account reconcilements?	Determine the frequency with which, and the responsible party who, periodically reviews bank account reconcilements. These are recommended quarterly to strengthen internal controls.	<input type="checkbox"/>	<input type="checkbox"/>
10. Does management notify the credit union's banks, as soon as possible, when an authorized individual on the account has resigned or is no longer an authorized user?	Review this with management.	<input type="checkbox"/>	<input type="checkbox"/>
11. Is board of director approval required prior to opening a bank account?	Review this with management.	<input type="checkbox"/>	<input type="checkbox"/>
12. Are reconciling items on the bank reconciliation cleared in a reasonable time frame?	Determine the timeframe it takes for reconciling items to clear the bank reconciliation. All reconciling items must include a reference date. Items outstanding over sixty days are a cause for concern and must be investigated.	<input type="checkbox"/>	<input type="checkbox"/>
13. Is a procedure in place to follow up on checks which are outstanding more than ninety days?	Determine if a procedure is in place to ensure checks clear timely and to investigate why long term outstanding checks do not clear in a reasonable time frame. Checks that do not clear within ninety days should be investigated and transferred to an accounts payable account.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 8A -- Internal Control Checklist: Cash

Test	Procedure	Yes	No
14. Does a policy limit exist for the maximum amount of cash which may be deposited in a particular bank account?	Determine whether or not the amount on deposit/average daily balance should be reasonable in relation to needs.	<input type="checkbox"/>	<input type="checkbox"/>
15. Does management evaluate financial institutions with balances over insured amounts?	Determine if a review of the financial condition of the institution is completed at least annually. Annual reports and financial statements should be on file to document this review.	<input type="checkbox"/>	<input type="checkbox"/>
16. Are check signing machines and/or stamps locked in a secure place to prevent unauthorized use?	Verify security exists and is adequate.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 8A -- Internal Control Checklist: Cash

Test	Procedure	Yes	No
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Wire Transfers - Internal Control Checklist.

(This checklist is designed for a general review of wire transfer internal controls. You should refer to more comprehensive materials to review internal controls for credit unions with Fedwire terminals.)

- | | | | |
|---|--|--------------------------|--------------------------|
| 1. Are individuals properly authorized to complete transfers? | Review the policy to determine. | <input type="checkbox"/> | <input type="checkbox"/> |
| 2. Is there a written policy which details instructions. | Review the policy to determine. | | |
| 3. Are there written agreements with the members who request wire transfers? | Determine if written agreements with members authorizing wire transfers are signed by the member and if they include a section detailing the credit union's liability. | <input type="checkbox"/> | <input type="checkbox"/> |
| 4. Is there a written agreement with the financial institutions for wire transfers? | Determine if an agreement with all financial institutions for wire transfers used is on file. | <input type="checkbox"/> | <input type="checkbox"/> |
| 5. Are financial institutions notified of credit union personnel changes? | Determine if the financial institution is notified of personnel changes to prevent unauthorized wire transfers. | <input type="checkbox"/> | <input type="checkbox"/> |
| 6. Are bank accounts with wire transfer activity reconciled by individuals who do not initiate transfers? | Recommended for proper segregation of duties. | <input type="checkbox"/> | <input type="checkbox"/> |
| 7. Are the number of employees approved to complete a wire transfer kept to a minimum? | Determine if the credit union has limited the number of employees approved to complete a wire transfer (review in relation to total employees). | <input type="checkbox"/> | <input type="checkbox"/> |

Appendix 8A -- Internal Control Checklist: Cash

Test	Procedure	Yes	No
8. Are wire transfer duties given to employees with higher seniority?	Determine if this is normally done. In general, new employees should not be given wire authority. An employee background check should be completed prior to assigning wire authority.	<input type="checkbox"/>	<input type="checkbox"/>
9. Are sufficient segregation of duties in place to prevent an employee from processing an entire wire transfer transaction without intervention from another employee?	Determine if internal controls are in place to prevent this problem and document them.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 8B -- *Cash In Bank Account Work Paper Instructions*

Cash In Bank Account Reconciliation.

How do we complete the review of the cash in bank account reconciliation?

You may photocopy the credit union's reconciliation for use in testing. You may use the *Cash In Bank Account Reconciliation Form* sample provided.

Follow the audit procedures for cash in bank, which are detailed in *Chapter 8*.

Review or complete a bank reconciliation for all cash in bank accounts on the general ledger. If an in-house draft account is used as the credit union's checking account, be sure to include the account(s).

How do we confirm cash in bank accounts?

Use the sample *bank confirmation* form provided. Send a confirmation to all cash in bank accounts as of the audit date. Include a stamped self addressed envelope for the reply.

The confirmation must be returned directly *to the supervisory committee for review*.

Review the bank confirmations received and compare the confirmed bank balance with the balance used on the bank reconciliation. Investigate any differences noted on the bank confirmation when comparing back to credit union records.

BANK ACCOUNT RECONCILEMENT

Credit Union:			
Name of Bank:			Audit date:
G.L. Acct. No.:			Reconcilement date:

A. BALANCE PER GENERAL LEDGER:

1. **Additions:** (Items added by bank but not yet entered on books of the credit union)

date	description	amount
<i>Total additions:</i>		0.00

2. **Deductions:** (Items added by bank but not yet entered on books of the credit union)

date	description	amount
<i>Total deductions:</i>		0.00

Adjusted General Ledger Balance: 0.00

B. BALANCE PER BANK STATEMENT:

1. **Deductions:**

Total Outstanding Checks: (enter total from Section D) 0.00

Other deductions:

date	description	amount
<i>Total deductions:</i>		0.00

2. **Additions:** (Items added by credit union but not yet entered on the bank's records)

G.L. date	description	Bank CR date	amount
	Deposit in transit		
<i>Total additions:</i>			0.00

Adjusted Bank Balance: 0.00

C. RECONCILIATION:

Book Balance (from Section A)	0.00
Bank Balance (from Section B)	0.00
Out-of-balance Condition (if any)	0.00

Appendix 8C -- Reconciliation Of Receipts To Deposits Work Paper Instructions

Reconciliation of receipts to deposits.

How do we complete the reconciliation of receipts with deposits?

Refer to the sample form *Reconciliation Of Receipts With Deposits*. The purpose of the reconciliation is to trace the bank deposits recorded on the general ledger (debits to cash in bank) with the deposit credits on the bank statement or a validated bank deposit receipt.

- Review the general ledger date of the deposit with the date of the bank credit.
- Deposit credits on the bank statement or deposit receipt should be dated within one to two days of general ledger debit.
- Investigate any differences when comparing the general ledger debit with bank credits.
- Complete a reconciliation of receipts with deposits for all general ledger accounts in which cash is deposited.

What is the testing period for the receipts with deposits test?

The recommended period for review is the month of the audit date through the date of the cash count. For example, if the audit date is December 31, and the cash count took place on January 15, the receipts with deposits test should be completed for the period of December 1 to January 15. The purpose of the test check is to ensure that deposits are made intact and on time, within the provisions for the FCU Bylaws. Undeposited amounts should be properly secured and reconciled.

Appendix 8D -- SAMPLE CONFIRMATION FOR CASH IN BANK

Date _____

Re: Bank account no. _____

Dear Sir or Madam:

The supervisory committee of the _____ Credit Union is conducting an audit of the books and records. Please confirm any balances for the account number listed above, as of _____. A stamped self addressed envelope is enclosed for your reply. Please respond directly to the Supervisory Committee. Thank you in advance.

Sincerely,

Supervisory Committee member,
_____ Credit Union

Authorized signature:

Manager/CEO
_____ Credit Union

Please provide balance information, as of _____:

Checking account balance \$ _____
Savings account balance \$ _____
Federal Funds balance \$ _____
Other account balance \$ _____

Loan or note payable balance \$ _____
Line of credit borrowing limit \$ _____
Collateral held for credit union liabilities: \$ _____
Safekeeping - securities held: \$ _____

Bank employee signature

Title/position

Date

Appendix 8E -- *Cash Count Work Paper Instructions*

Cash count

When is the best time to complete a cash count?

The cash count must be completed on a *surprise basis* for an effective cash count. Do not notify management and staff with the date and time of the count.

It is best to complete a cash count in the morning, *before the credit union opens for business*.

It is preferable to count the teller change fund *before any transactions take place*. If the count takes place before any transactions are processed, then the main part of the count will be to count the currency and coin.

If the cash count takes place after the teller posts transactions, then all of the transactions must be summarized to balance the drawer. It will take more time to complete the count.

In order to balance back to the general ledger and teller proof sheet:

- Checks and money orders received must be added.
- Cash withdrawal transactions must be summarized and included on the cash count sheet.

The vault cash should be counted before any transfers are made from the vault to the tellers.

How do we complete the cash count sheet?

A separate cash count sheet must be completed for each teller, vault, and any automated teller machine (ATM's) owned. After counting all cash and cash items (if applicable), total the cash count sheet and compare the total amount with the teller proof sheet (usually a balancing sheet generated by the computer system).

Investigate any difference noted with the cash count total and the required change fund amount from the proof sheet.

During the count, ask the teller if the drawer or vault contains bait money (pre-recorded money set aside in case of a robbery).

The teller signs the cash count sheet when the count is completed. You sign the cash count sheet when the count is completed.

**How do we
balance the cash
counted to the
general ledger?**

You must be certain that all teller and vault change funds were counted. Complete the *change fund recap*, which summarizes the funds counted. Total all of the individual teller and vault funds.

Compare the total cash counted with the effective date of the respective general ledger account balance. Investigate any significant differences. Include any significant difference in the audit report to the board of directors.

CASH COUNT

Credit Union: <input style="width: 95%;" type="text"/>	Audit date: <input style="width: 95%;" type="text"/>
Teller name/no.: <input style="width: 95%;" type="text"/>	Cash count date: <input style="width: 95%;" type="text"/>

A. Coins:

	Number of:		Total
	loose	rolls	
Pennies	1	1	\$ 0.51
Nickels	1	1	\$ 2.55
Dimes	1	1	\$ 5.10
Quarters	1	1	\$ 10.25
Halves	1	1	\$ 10.50
Dollars	1	1	\$ 21.00

\$ 49.91

Currency:

	Number:	Total
Ones	1	\$ 1.00
Twos	1	\$ 2.00
Fives	1	\$ 5.00
Tens	1	\$ 10.00
Twenties	1	\$ 20.00
Fifties	1	\$ 50.00
Hundreds	1	\$ 100.00

\$ 188.00

Other items:

Mutilated currency	\$ 1.00
Stamps	\$ 1.00
Tickets	\$ 1.00
	\$ -

\$ 3.00

Bait money:

\$ 1.00

Undeposited checks and money orders *

\$ 12,345.00

TOTAL CASH, CASH ITEMS, AND CHECKS: \$ 12,586.91

B. LESS: General Ledger Change Fund Balance:

\$ 150.00

C. LESS: Undeposited checks and money orders:

\$ 12,345.00

D. DIFFERENCE - cash (short) or over:

91.91

I hereby certify that funds shown on the "TOTAL CASH, CASH ITEMS, AND CHECKS" line were counted by _____ for the supervisory committee in my presence this _____ day of _____, _____ at (a.m., p.m.) and returned to me intact. These funds represent all funds of the credit union for which I am accountable. If there is a cash short or over condition noted, I agree with the difference.

Credit union employee - signature

Counted by supervisory committee representative - signature

Appendix 8F -- CHANGE FUND RECAP FORM

<input type="text"/> Change Fund Recap Date of cash count: <input type="text"/> Audit date: <input type="text"/>	Federal Credit Union
---	----------------------

Teller no.	Cash counted	Change fund amt	Difference Over or (short)
1	\$ 4,900.00	\$ 5,000.00	\$ (100.00)
2	\$ 5,000.00	\$ 5,000.00	\$ -
3	\$ 5,000.00	\$ 5,000.00	\$ -
4	\$ 5,000.00	\$ 5,000.00	\$ -
5	\$ 5,000.00	\$ 5,000.00	\$ -
6	\$ 50,000.00	\$ 50,000.00	\$ -

Totals	\$ 74,900.00	\$ 75,000.00	\$ (100.00)
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Balance per G.L.	\$ 75,000.00
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Difference	\$ (100.00)
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Compare total cash counted with the respective general ledger account balance for the effective date of the count.

If there is a significant difference between the change fund counted and the general ledger balance, include this in your audit report.

Appendix 8G -- *Travelers Checks Work Paper Instructions*

Travelers checks count.

How do we complete the travelers checks count?

You use the *travelers checks inventory form*, a sample form is included. List the starting and ending serial numbers for each pack of travelers checks. Write down the number of travelers checks in the set. Write down the denomination of the travelers checks, usually \$20, \$50 or \$100. Write down total dollar amount in the series of travelers checks counted.

After counting the travelers checks inventory, compare the total counted with the total on the credit union's subsidiary record or log. Investigate any difference noted on the confirmation reply letter.

How do we confirm the travelers checks inventory?

After the count is reconciled, complete the travelers checks confirmation. Include a copy of the travelers checks inventory with the confirmation. Include a stamped self addressed envelope for the reply.

The confirmation must be returned *directly to the supervisory committee for review*.

Review the confirmation from the travelers checks company and research any differences noted in the confirmation reply.

Appendix 8H -- SAMPLE TRAVELERS CHECKS CONFIRMATION

Date_____

Account no._____

Dear Sir or Madam:

The supervisory committee of the _____ Credit Union is conducting an audit of the books and records. Please confirm the attached copy of the travelers checks inventory as of _____. Please detail any differences noted. A stamped self addressed envelope is enclosed for your reply. Please respond directly to the Supervisory Committee. Thank you in advance.

Sincerely,

Supervisory Committee member,
_____ Credit Union

Authorized signature:

Manager/CEO
_____ Credit Union

Signature - Representative of travelers checks company Date

Chapter 9 -- HOW DO WE AUDIT INVESTMENTS?

- 9.01 To help us get started, could you provide us some background on investment assets?**
- 9.02 What are our audit objectives?**
- 9.03 What are our audit procedures?**
- 9.04 How do we test internal controls?**
- 9.05 How does management classify investments?**
- 9.06 How do we verify the accuracy of the general ledger accounts?**
- 9.07 How do we verify investment accounts with supporting records?**
- 9.08 How do we verify the balances listed on the investment report?**
- 9.09 How do we review the premium or discount?**
- 9.10 How do we determine whether accrued income is reasonable?**
- 9.11 How do we confirm the ownership and existence of investments?**
- 9.12 How do we verify the accuracy of the investment fair value section on the financial statements?**
- 9.13 How do we verify the accuracy of the investment maturity breakdown on the financial statement?**
- 9.14 What do we need to document?**
- 9.15 What if we determine through testing that internal controls are not working as intended?**

Appendices

- 9A *Internal Control Checklist: Investments***
- 9B *Investment Control Worksheet Instructions*
*Investment Control Worksheet***
- 9C *Standard Investment Confirmation***
- 9D *Securities Confirmation***
- 9E *Broker Account Confirmation***

NOTE: This Guide is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the Federal Credit Union Act and the National Credit Union Administration Rules and Regulations §715.

To help us get started, could you provide us some background on investment assets?

9.01 Investments are used as a *temporary* vehicle to hold excess funds and as part of an overall asset/liability management strategy. A certain amount of funds needs to be readily available for share withdrawals, loans, and operating expenses. Usually the credit union will have a deposit account, such as at the corporate, to hold immediately available cash. Other investments are held with staggering maturities to provide funds on an ongoing basis. If the credit union's loan demand is low, management may choose to invest the member's shares.

Types of Investments. The credit union's investment portfolio may contain a variety of investment instruments. A few of the more common investments are:

- a) A deposit account. There are no restrictions for withdrawals, e.g., the credit union's checking account. This is the most readily available source of funds.
 - b) A certificate of deposit. These investments are normally purchased from local banks or other financial institutions and mature on a specified date. There is usually a substantial penalty for withdrawing the funds early.
 - c) Federal Funds. "Fed funds" are overnight deposits. Funds are normally taken from an account at the end of the day, and credited back the next morning. The purpose of the transaction is to provide additional interest income to the credit union.
 - d) US Treasury Securities. The U.S. Government issues and fully guarantees these investments. Treasury issues include bills, notes and bonds. US Treasuries have a specific maturity date, ranging from 3 months to 30 years.
 - e) US Agency Securities. These investments are issued by agencies of the federal government, e.g., Freddie Mac, Fannie Mae, and Sallie Mae. They are backed by different collateral, depending on the agency that issues them. Accounting for these investments depends on the collateral involved, and the way it was purchased.
 - f) Other Investments. There are many other investments in
-

which credit unions can invest. Some investments are not allowable for credit unions. *Other investments, including derivatives of #d and #e above, are beyond the scope of this guide.* Your committee should refer to the *AICPA Credit Union Audit Manual*, the AICPA guide for *Audits of Credit Unions*, or an outside accountant for assistance in these cases.

Obtaining Investments. Credit unions purchase investments from different sources:

- Directly from the provider. Of course, the credit union works directly with the provider for deposit accounts. Certificates of deposit can be made directly with the issuing institution. U.S. Treasury securities can be purchased directly from the U.S. Treasury.
- Through a broker. Certificates of deposit, US Treasuries, and Agency securities can be purchased through a broker. The documentation that you review will differ from that provided directly from the issuer.

What are our audit objectives?

9.02 Your audit objectives are:

- a) Determine whether internal controls over investment transactions are adequate.
 - b) Verify that management classifies securities when acquired as either held-to-maturity, available-for-sale or trading.
 - c) Ensure that management has properly recorded and reported investments, related accounts, and fair values.
- Verify that management has recorded all investments owned, and related investment transactions in the appropriate period.
-

- Verify that management has recorded and reported realized and unrealized gains/losses, accrued income, investment income, and unamortized premiums/discounts appropriately.
 - d) Verify the ownership and existence of the investments. Verify that investments are either on hand, or held in safekeeping.
 - e) Determine compliance with NCUA Rules and Regulations and credit union board policy.
-

What are our audit procedures?

9.03 Your audit procedures are:

- a) Test the internal control structure surrounding investments to identify any internal control weaknesses.
 - b) Determine how management classified investments.
 - c) Verify the accuracy of the general ledger investment and related accounts.
 - d) Confirm the ownership and existence of the investment.
 - e) Verify the accuracy of the investment fair value and maturity sections of the financial statements.
-

How do we test internal controls?

9.04 You will need to review board minutes to determine the extent of the board's involvement, and review the board's investment policy. Complete the internal control checklist accompanying this chapter. You will obtain your answers from discussions with staff and observation. You should *verify this information throughout your investment review* as you look at the supporting documentation.

If there are material weaknesses in the internal control structure, you should complete the review on ALL investments. Your audit

report should include findings on internal control weaknesses when it is feasible for the credit union to revise practices to strengthen them. You should confirm ownership of ALL investments.

Due to the limited control structure of credit unions with small staffs (i.e., less than 5 employees), committee members must apply procedures for all investments.

How does management classify investments?

9.05 With regard to investment securities, management must assess its intent and ability with regard to the securities. Based on this assessment, management must classify securities as either “Held to Maturity” (HTM), “Available for Sale” (AFS), or “Trading.” An extensive discussion of trading securities is beyond the scope of this guide. Deposit accounts, certificates of deposit (for the most part), and fed funds are not securities and management should not classify these in any of the three categories.

HTM. The HTM classification signifies that management intends to hold the investment until it matures. The value should be adjusted for the amortization of premiums or discounts on the credit union’s records. The balance of the investment account should tie to the original supporting documentation or a supporting record of amortization.

AFS. The AFS classification signifies that management will sell the investment if they need the funds for other purposes. In this case, they should adjust the investment account to fair value on a periodic basis. You will verify the balance of AFS investments by tying to the fair value of the investment, and reviewing the account history.

Management should evaluate the classification, with any necessary adjustments of fair value recorded, at least every dividend period.

How do we verify the accuracy of the general ledger accounts?

9.06 While completing these tests, remember to also review for compliance with board policy and your assumptions on internal controls:

- a) Verify the accuracy of the general ledger accounts with detailed subsidiary records. Subsidiary records may include broker statements, manual ledgers, computer generated worksheets, etc. Include:
 - Investments.
 - Premiums/Discounts.
 - Accrued Income.
- b) Verify the accuracy of the detailed subsidiary records, and any other documentation maintained by management.
- c) Review history on premiums/discounts, if any, and verify that amortization periods are reasonable.
- d) Review the accrued interest on a sample of investments for reasonableness.

How do we verify investment accounts with supporting records?

9.07 You should verify investment general ledger accounts by tracing amounts to subsidiary records, as follows:

- a) Obtain a detailed investment report. If the credit union does not have a detailed list of investments, developing your own report will facilitate and support your review. We included a sample in the appendix to this chapter.
 - b) Total the balances on the list, and tie the results to the corresponding general ledger accounts as listed on the trial balance. Complete this review on the investment balances and any other applicable accounts--premiums/discounts and accrued income.
-

How do we verify the balances listed on the investment report?

9.08 Once you verify that general ledger accounts equal the balances on your investment list, you should verify that the supporting records are accurate. Complete the following steps:

- a) Choose a sample of investments from your investment report to tie to supporting documentation, if investment internal controls are adequate. Select every “Nth” investment. You should review at least a few investments purchased since the prior audit. If your internal control review indicated weak controls, you must review the entire investment portfolio.
 - b) Request that management provide you with the supporting documentation for all investments (“investment files”). Even if you selected a sample, you should obtain the address for the confirmations directly from supporting documentation.
 - c) For all DEPOSIT accounts, tie the balance of the account directly to the month end statement from the issuer. If these amounts do not directly correspond, refer to Chapter 8, the “How Do We Audit CASH?” chapter for directions on reviewing reconcilements.
 - d) For FED FUND accounts, documentation to support these deposits varies. Trace the balance on the general ledger to any support for the account, and ensure that the interest recorded for these investments is reasonable. Be sure to confirm all fed funds accounts, as indicated in the following paragraph.
 - e) For ALL OTHER INVESTMENTS, trace the following from your report to the supporting documentation:
 - Amortized cost--If the investment is depository in nature, or is classified as HTM.
 - Fair value--If AFS or trading, trace to the current fair value.
 - Maturity.
 - Stated rate.
-

- Original premium/discount.

If purchased from a broker, ensure that the board has authorized use of the broker in the investment policy.

You could complete the investment confirmations using the addresses listed in the file during this review. You need send only one confirmation request to a broker that sold the credit union more than one investment.

- f) What if the balance of the federal agency security doesn't tie to the broker's confirmation? Most federal agency securities pay back principal throughout the life of the investment.

- Review the history or management's detailed subsidiary of the investment account to ensure that it appears reasonable. You should see reductions in the principal amount of the investment.
- Trace a small sample of these principal payments to supporting documentation (management should have copies of the checks received in the file, along with support for the entry made when they received the check).

Refer to the workpaper instructions for additional clarification on completing the above steps. See Appendices 9C, 9D, and 9E for sample confirmations.

How do we review the premium or discount?

9.09 Premiums or Discounts. When an investment has an interest rate that is higher or lower than market rates, a broker will compensate for the difference in yield by adjusting the price of the investment. If the stated interest rate is higher than the market rate, the credit union will pay more than the stated value. In this case, management purchased the investment at a "premium." If the stated interest rate is lower than market, you will not pay full price for the investment. Management would purchase it at a "discount." The credit union should write-off the premium or

discount over the life of the investment. The *Accounting Manual for Federal Credit Unions* discusses the proper accounting treatment for premiums and discounts.

Steps. If the premium or discount is material:

- a) Obtain a history of the amortization of the premium or discount. Management may have maintained a separate record of the account, or you may need to review the general ledger history. Ensure that the history is reasonable. If the credit union maintains a separate subsidiary, ensure that the ending balance corresponds with the general ledger balance.
 - b) Review the amortization period used, and compare to the investment to ensure that the write-off period is reasonable.
-

How do we determine whether accrued income is reasonable?

9.10 You should complete the following steps to verify accrued income:

- a) Review the investment for interest payment patterns to determine at what point the security last returned interest. How many months of interest have been earned but not paid?
 - b) Determine the annual interest the investment should pay, and convert this figure into the period determined in #a above.
 - c) Compare this figure with the income that the credit union accrued for the investment. The balances should be similar.
 - d) Do payment patterns correspond with the payment schedule indicated on the investment?
-

How do we confirm the ownership and existence of

9.11 You should send confirmation notices to holders of all of the credit union's investments. Complete the following steps:

- a) Complete a "Confirmation Notice" for ALL of the credit union's
-

investments?

investments. Refer to the appendices to this chapter for example forms. Use the addresses taken from the independent documentation in the files (someone could easily change addresses on the credit union's records).

- b) Mail the form directly to the institution. Do not use staff to assist you in this process.
- c) Check off the investments on your investment report as the confirmations come back.
- d) Review the confirmation for any discrepancies.
- e) Research differences thoroughly to obtain an adequate explanation. The difference may simply be a result of timing or a simple error. You should immediately bring material, inadequately explained differences to the board's attention.
- f) One to two weeks after you mailed the confirmations, review your investment report for any confirmations that you haven't received. Send second notice requests to the institutions. Repeat this process again if institutions haven't returned confirmations. As a last resort, call any institutions from which you still haven't received confirmations.

How do we verify the accuracy of the investment fair value on the financial statements?

9.12 Financial statements should footnote fair values of the entire investment portfolio. You should verify the accuracy of these figures by completing the following steps:

- a) Complete the fair values section on your investment report.
 - b) Trace the fair values to management's supporting documentation. Management may use a statement obtained from the broker, a newspaper such as the Wall Street Journal, or other recognized information provider. Contact a broker or other information provider to verify values if they appear unreasonable or you cannot obtain the information from management.
-

- c) Total the fair values on your investment report by investment category, and use this figure to verify the balance listed on the financial statement.
-

How do we verify the accuracy of the investment maturity breakdown on the financial statement?

9.13 The financial statements should categorize investments by maturity (usually “Less than one year” and “Over one year”). You should verify that management has accurately reported maturities by completing the following steps.

- a) Total all investments for each investment type on your investment report that have a remaining maturity of less than one year. Use fair value for all AFS investments, and amortized cost for all remaining investments.
 - b) Determine the amount remaining for all other maturity and type categories.
 - c) Verify that management used these figures for the financial statements.
-

What do we need to document?

9.14 Document *ALL* of your reviews. You need to provide evidence that you reviewed all necessary areas. At a minimum, retain copies of all confirmations and any follow-up correspondence, copies of worksheets used in the review, and the completed internal control checklist (Appendix A).

What if we determine through testing that internal controls are not working as intended?

9.15 You may note during a more in depth review of the investment area that internal controls are not working as intended. You should:

- a) Take another look at the internal control questionnaire to determine if the noted weakness is material.
-

- b) If the weakness is material, you should revise your investment review to include additional testing.
-

Appendix 9A -- Internal Control Checklist: Investments

The following checklist is designed to assist you to review internal controls and identify any weaknesses. You may find additional guidance in the AICPA's "Audits of Credit Unions" and/or "Credit Union Audit Manual."

Internal Controls:

Test	Procedure	Yes	No
1. Is the board's investment policy sufficient to safeguard assets?	Review the board's policy for authorization of the person making the investment, types, maturity limits, dollar limits, approved brokers, etc. Policy should provide a structure for safe investment practices.	<input type="checkbox"/>	<input type="checkbox"/>
2. Is management complying with the policy?	Briefly scan investment reports. Test for this control during your substantive tests.	<input type="checkbox"/>	<input type="checkbox"/>
3. Does the board review investment transactions?	Verify that the board incorporates investment transaction reviews into the monthly board minutes. This serves to increase awareness and assures that the board monitors activity.	<input type="checkbox"/>	<input type="checkbox"/>
4. Do investment reports include enough detail to appropriately inform the board of potential risks involved?	Determine if the reports include a sufficient description of the investment, unrealized market loss (on agencies, treasuries), maturity, yield, and investment activity.	<input type="checkbox"/>	<input type="checkbox"/>
5. If management uses brokers, does the board evaluate them?	Determine if management has reviewed the broker's financial condition, reputation, and insurance. The credit union should also have a signed account agreement.	<input type="checkbox"/>	<input type="checkbox"/>
6. Does the board approve investment and related account write-offs?	Verify that the board approves all write-offs (for example, loss of interest, premium write-off, other-than-temporary decline in market values, etc.). Routine adjustments to fair value do not require approval from the board of directors.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 9A -- Internal Control Checklist: Investments

Test	Procedure	Yes	No
7. Does the internal auditor or another independent party conduct their own investment reviews?	Review and follow-up of authorization, existence, appropriateness, classification and record keeping reduces the risk of inappropriate activity and errors. (You should review their documentation.)	<input type="checkbox"/>	<input type="checkbox"/>
8. Does a committee or an individual make investment decisions?	Determine who makes investment decisions. Delegating decisions to a committee, rather than an individual, reduces the risk of poor or inappropriate decisions. Board policy should specifically define their authority, and it should be reasonable.	<input type="checkbox"/>	<input type="checkbox"/>
9. Does the board delegate investment decisions to a broker or investment service?	Examine board delegations. Management should research the investment service prior to use and always require a written contract. The contract should provide clear, appropriate limits to reduce risk.	<input type="checkbox"/>	<input type="checkbox"/>
10. Who has management authorized to redeem investments?	Determine if a separation of duties exists. Persons with access to the investments should not post to or reconcile the investment records. This separation exists to prevent unauthorized access to investment funds without immediate detection.	<input type="checkbox"/>	<input type="checkbox"/>
11. If the credit union purchases investments from brokers, are the investments in safekeeping with a third party?	Determine where investments are safekept. Having another institution hold investments ensures that the broker will not use the investments to his advantage.	<input type="checkbox"/>	<input type="checkbox"/>
12. Does staff use a safety deposit box or vault for investments?	Do two credit union staff persons jointly access the safety deposit box? This reduces the risk of unauthorized removal, as it requires involvement from both employees.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 9A -- Internal Control Checklist: Investments

Test	Procedure	Yes	No
13. Is the credit union recorded as the owner of the investment?	Verify. All investments made directly with the issuing entity should be in the credit union's name. A broker should at least hold the investments for the credit union's account.	<input type="checkbox"/>	<input type="checkbox"/>
14. Does management analyze market values?	Determine if staff retain market value quotations (preferably using an independent source), and disclose these on the financial statements.	<input type="checkbox"/>	<input type="checkbox"/>
<hr/>			
Accounting Procedures:			
1. Are investments appropriately classified?	Investigate investment classification (Held to Maturity or Available for Sale), to determine the correct figures to use when verifying general ledger balances.	<input type="checkbox"/>	<input type="checkbox"/>
2. Are the investment general ledger balances accurate?	Trace general ledger balances to appropriate documentation, such as safekeeping receipts.	<input type="checkbox"/>	<input type="checkbox"/>
3. Are related general ledger balances accurate?	Trace supporting accounts to appropriate detail, or verify that they are reasonable if there is no support. Verify accrued income, premiums/discounts, Unrealized Gain/Loss account.	<input type="checkbox"/>	<input type="checkbox"/>
4. Do investors confirm that the credit union owns the investment?	Send confirmation notices for ALL investments. Track confirmations as you receive them to verify that all are returned and support the general ledger balances.	<input type="checkbox"/>	<input type="checkbox"/>
5. Are investment market values and maturity classifications on the financial statements accurate?	Verify with supporting documentation.	<input type="checkbox"/>	<input type="checkbox"/>
<hr/>			

Appendix 9B -- *Instructions for Sample Investment Control Worksheets*

Will we need to modify the worksheet?

You should tailor your report to the credit union's investment portfolio. For example, does management purchase any investments at a premium or a discount? If not, you do not need this section on the investment report. If the credit union does not accrue investment income, you do not need to include these columns.

If management's report does not include areas that you need, you could modify management's report, or develop your own to cover only the necessary areas.

We have provided two worksheets for you to use--one related to HTM investments, and one related to AFS investments.

What general ledger accounts can we verify using the HTM investment form?

You can use this worksheet (or a similar worksheet prepared by management) for several different accounts. The following numbers correspond to the numbers listed on the worksheet; keep in mind that you may need to add some totals to the AFS worksheet to obtain final values.

- (a) The investment general ledger accounts (accounts #740 through #759) should equal historical or amortized cost for most HTM investments, or the amortized value for premiums, discounts, and investments that have made principle payments.
 - (b) Accrued income should correspond to the accrued income general ledger accounts (#782 series).
 - (c) The financial statements should footnote fair values.
-

What general ledger accounts can I verify using the AFS investment form?

Again, the worksheet can be used to verify several different accounts. The following numbers correspond to the numbers listed on the worksheet; keep in mind that you may need to use some figures from the HTM worksheet to obtain fair values:

- (a) The investment general ledger accounts (accounts #740 through #759) should equal fair value. Premiums or discounts should equal amortized historical cost.
 - (b) The “Accumulated Unrealized Gains/Losses on AFS Securities” general ledger account #945 should equal the total unrealized gain or loss figure.
 - (c) Accrued income should correspond to the accrued income general ledger accounts (#782 series).
-

INVESTMENT WORKPAPER

Hold to Maturity Investments

Description	Maturity Date	Purchase Date	General Ledger Balance [1]	Par Value	Current Premium or Discount [1]	Accrued Income [2]	Market Value [3]	Investment Reviewed	Confirmation Sent	Confirmation Received
-------------	---------------	---------------	----------------------------	-----------	---------------------------------	--------------------	------------------	---------------------	-------------------	-----------------------

The following is an example of how your audit workpaper might look when completed:

CERTIFICATES OF DEPOSIT:										
Citibank	8/17/97	2/17/96	99,000.00			3,217.50		X	X	
First Int-Sacramento	12/22/96	12/22/95	100,810.06	100,000.00	810.06	833.33			X	X
TOTALS			199,810.06		810.06	4,050.83	N/A			
US AGENCY SECURITIES:										
GNMA 00395	12/15/03	6/12/96	76,523.90	N/A	596.05	3,542.17	75,124.30	X	X	
FHLMC	3/18/97	2/14/94	80,000.00		0.00	188.90	82,000.32		X	
TOTALS			156,523.90		596.05	3,731.07	157,124.62			
US GOVERNMENT OBLIGATIONS:										
T-note	10/31/96	7/31/96	497,315.00	500,000.00	-2,685.00	14,583.33	498,210.00	X	X	
T-note	3/24/99	3/24/94	150,000.00	150,000.00	0.00	3,125.00	145,918.00	X	X	
TOTALS			647,315.00	650,000.00	-2,685.00	17,708.33	644,128.00			

(USE THE CREDIT UNION'S LETTERHEAD)

Appendix 9C -- STANDARD INVESTMENT CONFIRMATION

(DATE)

(NAME AND ADDRESS OF INSTITUTION OR SAFEKEEPING AGENT)

Dear (NAME OF AGENT):

Our supervisory committee is conducting an audit of our financial statements. In that regard, please confirm the following investments, which our records indicate that you held on (FINANCIAL STATEMENT DATE).

Please compare this information with your records and complete the section below regardless of whether it agrees with your records. After signing and dating your reply, please mail it directly to the supervisory committee in the enclosed reply envelope. Thank you in advance for your prompt reply.

Sincerely,

(MANAGEMENT'S NAME/POSITION)
(NAME OF CREDIT UNION)

(LIST INVESTMENT(S) HERE OR PROVIDE A SEPARATE LIST. INCLUDE NAME OF INVESTMENT, AMOUNT OUTSTANDING, AND MATURITY DATE))

The *above/attached* agrees with our records as of (FINANCIAL STATEMENT DATE), with the following exceptions:

Signed: _____ Date _____
(Name and Title/Position)

(USE THE CREDIT UNION'S LETTERHEAD)

Appendix 9D -- SECURITIES CONFIRMATION

(DATE)

(NAME AND ADDRESS OF BROKERAGE FIRM OR
SAFEKEEPING INSTITUTION)

Dear (NAME OF BROKER/SAFEKEEPING AGENT):

Our supervisory committee is conducting an audit of our financial statements. In that regard, please confirm the following securities which our records indicate that you held on (FINANCIAL STATEMENT DATE).

Please compare this information with your records and complete the section below regardless of whether it agrees with your records. After signing and dating your reply, please mail it directly to the supervisory committee in the enclosed reply envelope. Thank you in advance for your prompt reply.

Sincerely,

(MANAGEMENT'S NAME/POSITION)
(NAME OF CREDIT UNION)

(LIST SECURITIES HERE OR PROVIDE A SEPARATE LIST. INCLUDE NAME OF INVESTMENT, AMOUNT OUTSTANDING, AND MATURITY DATE.)

The *above/attached* agrees with our records as of (FINANCIAL STATEMENT DATE), with the following exceptions:

Signed: _____ Date _____
(Name and Title/Position)

(USE THE CREDIT UNION'S LETTERHEAD)

Appendix 9E -- BROKER ACCOUNT CONFIRMATION

(DATE)

(NAME AND ADDRESS OF BROKERAGE FIRM)

Dear (NAME OF BROKER):

Our supervisory committee is conducting an audit of our financial statements. In that regard, please send a statement of our account with you as of (FINANCIAL STATEMENT DATE) and include:

1. Securities held by you for our account.
2. Any amounts payable to or due from us.

After signing and dating your reply, please mail it directly to the supervisory committee in the enclosed reply envelope. Thank you in advance for your prompt reply.

Sincerely,

(MANAGEMENT'S NAME/POSITION)
(NAME OF CREDIT UNION)

The attached statement is a complete and accurate copy of all investments held with (NAME OF BROKERAGE FIRM).

Signed: _____ Date _____
(Name and Title/Position)

Chapter 10 -- HOW DO WE AUDIT LOANS?

- 10.01 What is our audit objective?**
- 10.02 How do we learn about the credit union's system of internal controls over the lending activity?**
- 10.03 What are some additional considerations in reviewing internal controls over the lending function?**
- 10.04 What audit procedures must we perform?**
- 10.05 How do we audit record keeping?**
- 10.06 How do we review loan policies?**
- 10.07 How do we determine our loan sample?**
- 10.08 How do we document our review?**
- 10.09 Are the loan terms within policy and/or regulations?**
- 10.10 Is the loan properly documented?**
- 10.11 Is the borrower willing to repay the loan?**
- 10.12 Is the borrower able to make the loan payments?**
- 10.13 Could you discuss with us the sample workpapers appended to this chapter?**

Appendices

- 10-A *Loans Internal Control Checklist***
- 10-B *Trial Balance of Members' Loans Workpaper***
- 10-C *Loan Review Workpaper***

What is our audit objective?	10.01 The audit of loan assets, including lending internal controls, provides essential feedback to the credit union's board of directors, who must safeguard the credit union's primary asset -- the loans to its members. Board policy should govern lending. Policy sets the standards for adequate financial and credit history analysis of borrowers, as well as specifying the required loan documentation. Accordingly, you need to review loans for compliance with policy in these three areas. You must also obtain a reasonable assurance that loans exist and are granted to real persons, and that loan transactions are properly recorded.
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NOTE: *This Guide is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the Federal Credit Union Act and the National Credit Union Administration Rules and Regulations §715.*

How do we learn about the credit union's system of internal controls over the lending activity?

10.02 Attached at the end of this chapter is a sample loan internal control checklist, Appendix 10-A (chk1st10.doc) which can help you.

What are some additional considerations in reviewing internal controls over the lending function?

10.03 Your review of internal controls in place over lending must include interviewing staff and management, and reviewing board minutes and the credit union's procedure manuals. Specific considerations in assessing internal controls include:

- a) Environmental factors, such as:
 - A well defined reporting system is in place to provide loan information to the board of directors for their business decisions and monitoring of lending.
 - Loan policies have sufficient detail to control and standardize loan decisions.
 - Management has an on-going program of internal loan review designed to identify problems and maintain quality.
 - b) Policies and procedures. The credit union should have a sound segregation and control of duties among those who:
 - **Approve loans.** Only properly authorized loan officers or committees should be making lending decisions. Personnel should analyze a member's financial ability and credit history before he/she grants a loan.
 - **Control files.** Loan documents should be kept in secure, locked, fireproof cabinets. Negotiable collateral should be under dual-access control. Management should regularly review loan documents to ensure completeness and accuracy.
-

- **Receive payments.** Monitoring practices must ensure that late payments are identified and followed up, and delinquency is properly reported.
 - **Post or reconcile records.** Subsidiary records must be maintained and reconciled to the General Ledger on a timely basis. Any differences must be resolved immediately. Management should regularly review and approve reconcilements, and must ensure that interest income is being properly accrued and recorded.
-

What audit procedures must we perform?

10.04 Generally, the audit procedures you perform must be designed to:

- a) Verify the accuracy of record keeping.
- b) Ensure loan policies set by the board of directors are followed.
- c) Review a sample of each loan type offered.

More specifically, you must review the credit union's system of internal controls over the lending activity and perform audit tests on loan receivables addressing whether:

- Loans exist at a given date and recorded transactions occur during a given period.
 - All loan transactions and accounts that should be presented in the financial statements are so included.
 - Loans are included in the financial statements at appropriate amounts.
 - Loans represent the rights of the credit union at a given date.
 - Loans are properly classified, described and disclosed.
-

How do we audit record keeping?

10.05 Attached at the end of this chapter is a **sample loan review workpaper**, Appendix 10-C (chptr10.xls), for this audit step.

The general ledger control account for *Loans to Members* (Account No. 701) should equal the sum of all the individual loan accounts itemized on the credit union's "Trial Balance of Members' Shares and Loans." You should report any out-of-balance condition to the board of directors, and ensure staff begins taking corrective action.

Some of the other key reviews include:

- Accrued interest on loans.
- Accuracy of interest being charged on members' loans.
- Interest refunds on loans.

Accrued Interest on Loans. This area is subject to errors and/or fraudulent transactions that can inflate or deflate the credit union's net income condition. The account balance represents interest owed to the credit union but not yet collected. For example, if a member's loan payment arrives in mid-month, the credit union records the interest earned up to that time, and can also *accrue* the amount of interest earned-but-not-yet-collected for the last half of the month.

Accuracy of Interest Being Charged on Loans. As a rule-of-thumb, the general ledger account balance should equal approximately one-half the amount of loan income for a month *plus* 3 months of earnings from delinquent loans.

Interest Refunds on Loans. Management will sometimes refund part of the interest paid by members in a period in order to distribute excess retained earnings or to stimulate loan demand. You should recalculate refunded amounts for a sample of members' accounts to verify the funds are properly allocated.

**How do we
review policies?**

10.06 You should read the credit union's loan policies before selecting a loan sample or looking at individual loans. Loan policies should exist for each type of loan offered by the credit union and policies should address all terms, i.e., interest rate, maturity, collateral, late fees, etc. The board of directors sets policies to meet the needs of members as well as to control lending. You should consider bringing to the board's attention any policies that seem out of touch with your sense of what other lenders offer. When satisfied that policies are sound, you can review loans to determine if practices follow policies. Keep in mind that the board sets policy and can also permit exceptions. Exceptions that arise in your loan review should be approved by the board. If approval is delegated to staff, the board should review and affirm exceptions at their next board meeting. Keep in mind that the board *can't* approve exceptions to statutory or regulatory limits.

**How do we
determine our
loan sample?**

10.07 You should look at a random sample of each loan *type* offered by the credit union. Loans typically have a "type" code that will help you make your selection. It is important to stratify your sample so you look at a cross-section of the total loan portfolio. For example, although you would look at most if not all insider loans, you might decide a suitable sample from each type of: unsecured, automobile, credit card, delinquent, charged off, first lien real estate, second lien real estate, and loan concentrations in excess of \$100,000. You should be aware of, and take appropriate samples from, any "off-line" loan trial balances such as credit cards, real estate, student loans, and automobile leasing.

The actual *number* of loans you select for review of each type depends on the size and complexity of the loan portfolio, and the credit union's system of internal controls. The sample size should be based on defensible judgment. Whatever number of loans you select for review, always look at enough loans so you are comfortable that you understand how well lending practices compare to loan policies. You should place special emphasis on the following loan types:

- **Real estate mortgage loans:** A wide range of documents are necessary for sound lending. Review of the appraisal report is especially critical, an area that is often subject to abuse leading to under-collateralized loans that may result in eventual large losses to credit unions.
- **Business loans:** In addition to the specified documentation for sound lending, be aware of the need for ongoing awareness of loan and collateral status. Monitoring practices should include documenting an ongoing, periodic analysis of the business financial condition in conjunction with inspections of the loan collateral. (Refer to NCUA Rules and Regulations 723)).
- **Construction loans:** Internal controls should require project inspections by staff in conjunction with the periodic requests for disbursements. Similarly, disbursements should be supported by copies of lien waivers from subcontractors and material suppliers, which personnel should obtain before release of funds. (Refer to NCUA Rules and Regulations 723).
- **Participation loans:** Audit procedures should be similar to that of direct loans, except you should consider confirming the actual balances of some or all loans with the servicer.

How do we document our review?

10.08 Use a workpaper to record the loans you review and make sure you review the appropriate areas. At the end of this chapter, you will find a **sample loan review workpaper** (chptr10.xls) you can copy and use, or modify to meet your special needs. Any workpaper you use should have enough details to document that you addressed the following questions:

- a) Are the loan terms within policy and regulations?
 - b) Is the loan properly documented?
 - c) Is the borrower willing to repay the loan?
 - d) Is the borrower able to make the loan payments?
-

Are the loan terms within policy and/or regulations?

10.09 When reviewing loans, you should question the approval of any loan that exceeds the limits set by the board of directors, such as:

- The Annual Percentage Rate (APR).
- The size of the loan.
- The repayment period.

NCUA sets some specific maximum limits on these same factors that board policy may not exceed. If you find more than a few such irregularities, the overall control of lending is weak and you should report it to the board of directors. Also, loans found outside of the legal limitations need to be corrected wherever possible.

Is the loan properly documented?

10.10 You should:

- Look for a signed loan application or other evidence that establishes the existence of the borrower, and shows that the borrower asked for the loan. You should question incomplete loan applications.
 - Look for a signed loan note or other evidence of the legal contract between the borrower and the credit union.
-

Is the borrower willing to repay the loan?

10.11 The loan file most often will include a recent credit report, which is the primary tool to evaluate the willingness or ability to repay. A borrower's past experience with other creditors is usually a good indicator of future performance. More than a few repayment irregularities reflects a higher risk than normal, in which case something in the loan file should record that the credit history was considered in the loan decision-making and that the higher risk was deemed acceptable. If you find more than a few such high-risk decisions, consider reporting to the board of directors that loan delinquency and losses may rise in the future.

Is the borrower able to make the loan payments?

10.12 The primary tool used to evaluate a borrower's ability to repay the loan is a credit analysis. A debt ratio calculation is a typical method of evaluating the borrowers' financial ability, although some credit unions use alternative procedures, such as a credit scoring system, to accomplish the same purpose. Whatever is used, however, should be reasonable and should be documented for review purposes in the loan files. You should consider reporting a general concern to the board of directors if you find numerous instances where the repayment ability is either not documented or not evident.

NOTE: Loans can be granted to borrowers with high debt-to-income ratios if the number of people in the borrower's family can be reasonably supported by the *net disposable income* after paying regular bills. For example, a high debt ratio can be considered acceptable for a small family with a large gross income. Debt ratios are useful "warning flags" to show when to do a disposable income analysis, and not as a fixed criteria for denying loans.

Could you discuss with us the sample workpapers appended to this chapter?

10.13 The three attached workpapers are examples that you can use to develop your own working papers. They are not all-inclusive, and should be modified according to the level of internal controls in your credit union.

See the instructions provided for each.

Appendix 10-A -- Instructions for Internal Control Checklist: Loans
(chklst10.doc)

What does this checklist accomplish?

Completing this workpaper should give you a basic understanding about the internal controls in place and operating over loan activity by the credit union. The checklist is designed to assist you in the loan internal control review.

How do we complete the Checklist?

You will need to prepare a number of working papers in the process of answering some questions on the checklist. We provide two sample workpapers in this chapter:

1. Trial Balance of Individual Loans.
2. Loan Review.

About halfway through the checklist, you will have enough understanding of the credit union's internal control condition to decide the size of your loan sample, and to perform your review of individual loan files. After this loan review, you will be able to finish this checklist and, based on the results, decide if you need to do any extra sampling.

Appendix 10-A -- Internal Control Checklist: Loans

The following checklist should help you identify significant internal control or operating weaknesses. You may find additional guidance in the AICPA's "Audits of Credit Unions" and/or "Credit Union Audit Manual."

Test	Procedure	Yes	No
1. Is the general ledger in balance with the individual loans?	Reconcile the GL balance with the Trial Balance of Individual Shares and Loans. (Note: Any <i>different</i> EDP system totals, such as a credit card program, should be added to the Trial Balance totals.)	<input type="checkbox"/>	<input type="checkbox"/>
2. Are interest charges correct?	Test-check a sample of members' statements having loan payments. Recalculate the finance charges to make sure the EDP is computing the correct amounts.	<input type="checkbox"/>	<input type="checkbox"/>
3. Are interest refunds correct?	Check for proper approval by the board of directors. Test-check a sample of individual refunds to see if the computer program is set up for the right refund amount.	<input type="checkbox"/>	<input type="checkbox"/>
4. Is accrued interest correct?	Review the balance in the accrual account for reasonableness. Reconcile the detailed transactions to the general ledger control balance.		
5. Is loan delinquency accurately stated?	Verify loan delinquency accuracy. What is the loan delinquency history and trends? Does the evidence identify any unusual risk that would warrant more extensive loan testing?	<input type="checkbox"/>	<input type="checkbox"/>
6. Are any loans to officials or employees delinquent?	Check the amortization of outstanding loans to these parties to determine if the loans are being repaid in accordance with the terms of the note. Any loans determined to be delinquent but not being reported as such must be disclosed immediately to the board and surety. Also, officials have a fiduciary responsibility to safeguard the assets of the credit union. An official with a delinquent loan is not fulfilling this responsibility.		

Appendix 10-A -- Internal Control Checklist: Loans

Test	Procedure	Yes	No
<p>NOTE: At this point, you might decide to determine the size of your loan sample and review some individual loans, in order to complete your evaluation of the following internal control criteria.</p>			
<p>7. Are loans properly disbursed?</p>	<p>Test-check some loan disbursement checks to ensure the check's date is <i>later than</i> the dates of the loan approval, and that the person approving the loan didn't <i>also</i> sign the check. Trace the transactions in the EDP system.</p>	<input type="checkbox"/>	<input type="checkbox"/>
<p>8. Did your sample of "insider" loans show proper approvals?</p> <p style="font-size: small; margin-top: 5px;">[R&R 701.21 (c)(3) and (d)(4)] [Bylaws VII or IX]</p>	<p>Verify proper approval for insider loans. The board must approve any loan to an official that, when added to other loans, exceeds regulatory limits for total indebtedness to the credit union (subtract any pledged shares).</p>	<input type="checkbox"/>	<input type="checkbox"/>
<p>9. Are terms for "insiders" the same as for other members?</p> <p style="font-size: small; margin-top: 5px;">[R&R 701.21(d)(5)]</p>	<p>Compare terms of "insiders" versus other members. Elected and appointed officials, and their immediate family members and business associates, can't get terms more favorable than regular credit union members.</p>	<input type="checkbox"/>	<input type="checkbox"/>
<p>10. Did your loan sample show proper loan documentation?</p> <p style="font-size: small; margin-top: 5px;">[Bylaws IX, 3][R&R 701.21(c)(3)]</p>	<ul style="list-style-type: none"> • Test for completed applications and notes, prepared in ink before signed. • Test for recent credit reports, with explanations for adverse items. • If collateralized, verify the credit union has valid title and insurance. 	<input type="checkbox"/>	<input type="checkbox"/>
<p>11. Did your loan sample show avoidance of repayment risk?</p> <p style="font-size: small; margin-top: 5px;">[Bylaws IX, 3][R&R 701.21(c)(3)]</p>	<p>Ensure that loan review illustrated, by debt ratio or other financial analysis, that the family unit can be supported by the borrower's debt-to-income condition.</p>	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 10-A -- Internal Control Checklist: Loans

Test	Procedure	Yes	No
<p>12. Did the sampled loans exceed limits set by the board or NCUA?</p> <p>[Bylaws IX, 3][R&R 701.21(c)(3)]</p>	<p>When reviewing the loan sample, compare loan terms to policy and NCUA regulations for incorrect or impermissible (a) size, (b) maturity, and (c) annual percentage rate.</p>	<input type="checkbox"/>	<input type="checkbox"/>
<p>13. Did your loan sample show approvals are documented?</p> <p>[Bylaws IX, 3]</p>	<p>Verify that the loan officer or credit committee approval are recorded in the individual loan files and in the permanent minutes/records of the credit union.</p>	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 10-B -- Trial Balance of Members Loans Workpaper
(chptr10.xls)

What is the purpose of this workpaper?

By completing this workpaper, you will verify (or dispute) that the general ledger control accounts accurately reflect the total of each member's loan balances.

How do I get started?

Obtain a copy of the credit union's Trial Balance of Members' Shares and Loans report as of your audit date. The name of this report may be slightly different, depending on your EDP vendor, but is basically an itemized list of all members' accounts in the credit union. If your credit union has more than one EDP system for accounts, such as a credit card vendor, you'll also need a list of those accounts.

How do we complete the workpaper?

This is a two-part workpaper, with typically no need to go past SECTION A *unless* the shares or loans are out-of-balance for the current month. SECTION B should be completed only to find out if an out-of-balance condition is on-going or just occurred.

SECTION A: Insert the totals of all loan types in the general ledger in the first set of input boxes. In the following set of boxes, put the totals from the detailed report of shares and loans. The workpaper computes and displays the amount of any differences.

SECTION B: Insert the loan data for the previous 2 months in the boxes provided. Differences are displayed, and you can now observe any changes in the out-of-balance amounts. If the differences don't change, you've found old errors. If the differences change, recordkeeping errors are still occurring.

An out-of-balance condition represents a breakdown of accurate and acceptable recordkeeping. In most cases, you can assume the total of the detailed listing of members' accounts is the true figure, because the members' accounts are verified biannually as correct and members generally report errors when their periodic statements are wrong. If the errors responsible for the out-of-balance condition can't be identified and corrected, the general ledger balance is adjusted to match the individual account totals. The adjustment creates either a loss or a gain.

Be aware that even a few dollars' difference can be significant. Sometimes very large errors might be involved which are offsetting each other between the share and loan control accounts.

What if the differences are due to old errors?

Staff should research and correct the errors. After a reasonable time and effort for corrections, such as 60 days, the differences should be written off and the general ledger brought into balance with the individual account totals.

What if the differences fluctuate?

The cause of the recordkeeping errors must be identified and corrected. Make, or cause to be made, test checks on a sample of members' accounts in order to identify what type of postings are causing the problem. Suggested minimum test checks are:

1. Start with a block of 25 member accounts at random which have had transactions during the first 10 days of the month you are auditing. Obtain printouts for the transactions on each of these 25 accounts.
 2. Obtain and have available all posting sources for the 10-day period, such as Cash Received Vouchers, payroll deduction listings, Journal Vouchers, etc. Obtain the detailed list of daily transactions for each of the 10 days.
 3. Compare each transaction on a member's account with the
-

source documents. Each transaction should be accounted for and matched to a proper source. Summarize and report any incorrect postings you identified.

4. If your review of the block of 25 accounts fails to indicate the cause of the out-of-balance condition, increase your sample until the cause is isolated.
-

What do I report?

You must report the situation to the board of directors. Your report can include the following recommendations:

1. Staff should be given a reasonable time limit to research errors and make corrections, such as 60 days, after which the board of directors should authorize and direct staff to adjust the general ledger account balances to bring them in line with the individual account totals.
 2. Adjusting entries should not be made until the board of directors is assured that recordkeeping problems have been resolved and the problem won't recur. After correcting the causes of the problem, adjusting entries should be deferred until the accounts are kept in balance for at least 3 months in a row.
-

What if my credit union doesn't use data processing?

Manual recordkeeping of members' share and loan accounts require additional committee controls and computations:

- You should get control of the ledger cards on a surprise basis, if at all possible, at the start of the audit.
 - Prepare an adding machine tape of the shares, and another of the loans, in order to complete this workpaper.
-

APPENDIX 10B -- TRIAL BALANCE OF INDIVIDUAL LOANS

Credit Union:	Ex Why Zee FCU	Audit Date:	12/31/96
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A. CURRENT BALANCES

	TOTAL LOANS
General Ledger balance for total loans:	200,000,000.00
Sum of individual accounts from the Trial Balance(s):	190,000,000.00
Potential adjustment/(write-off): [analyze below]	(10,000,000.00)

B. ANALYSIS OF DIFFERENCES - Previous 3 Months

	00/00/00	00/00/00	12/31/96
From the Trial Balance(s):	0.00	0.00	200,000,000.00
From the General Ledger:	0.00	0.00	190,000,000.00
Gain(Loss):	0.00	0.00	(10,000,000.00)

Describe actions by staff to correct differences shown in Sections A and B:

Appendix 10-C -- *Loan Review Workpaper* (chptr10.xls)

What is the purpose of this workpaper?

You can use this workpaper to control and document your review of individual loans.

What do I need to get started?

To complete this workpaper, you will need to get computer printouts of loans, preferably sorted by loan type. The size of your sample of each type depends on your assessment of the credit union's internal controls and your review of loan policies, so fill out the Internal Controls Checklist right away. Be aware that any other unusual factors can also affect the number of loans you select for review. For example, you may decide to increase the number of loans reviewed if you notice that loan delinquency is rising, in order to identify and report the cause of the problem.

What do we look for when reviewing loans?

This workpaper is designed to evaluate the soundness of loan decision-making. The focus is on three primary risk characteristics:

- Is the borrower able to repay the loan granted?
- Is the borrower willing to repay debt?
- Is the loan adequately documented?

Testing these three key parts of the loan practices is part of your responsibility to ensure that the credit union's practices and procedures are sufficient to safeguard members' assets. You will know if the board's plans, policies, and control procedures are properly administered, and are sufficient to safeguard against error, carelessness, and improprieties.

Chapter 11 -- HOW DO WE REVIEW THE “ALLOWANCE FOR LOAN LOSSES”?

- 11.01 What is the Allowance for Loan and Lease Losses?**
- 11.02 Who is responsible for the ALLL?**
- 11.03 In our role of validating the methodology, would you clarify what you mean by “methodology”?**
- 11.04 What are these “common elements” an ALLL methodology should have?**
- 11.05 In our role of overseeing and monitoring internal controls over the ALLL process, what should we focus on?**
- 11.06 What sorts of ALLL policies and procedures should we expect to find?**
- 11.07 Could you elaborate on the rules that govern establishing an ALLL?**
- 11.08 Could you expand on the requirements in relation to the ALLL under FAS 114?**
- 11.09 Could you expand on the requirements in relation to the ALLL under FAS 5?**
- 11.10 What documentation standards should the credit union meet?**
- 11.11 Could you be more specific concerning the documentation of ALLL methodology in written policies and procedures?**
- 11.12 Is there a lesser documentation burden for small credit unions?**
- 11.13 Could you provide some guidance on the process of consolidating the loss estimates?**
- 11.14 What should we focus on in validating the ALLL methodology?**
- 11.15 What documentation do we need to support the validation process?**

Appendices

- 11-A *ALLL Questions and Answers***
- 11-B *Allowance for Loan Losses Workpaper***
- 11-C *Allowance for Loan Losses Checklist***

What is the Allowance for Loan and Lease Losses?

11.01 An allowance for loan and lease losses (ALLL) recorded pursuant to generally accepted accounting principles (GAAP) is a credit union’s best estimate of the probable amount of loans and lease-financing receivables that it will be unable to collect based on current information and events. Loans are considered impaired when, based on current information and events, it is probable that the creditor will be unable to collect all interest and principal payments due according to the contractual terms of the loan agreement. The ALLL is reported as an asset valuation account.

For financial reporting purposes, including regulatory reporting, the provision for loan and lease losses and the ALLL must be determined in accordance with GAAP. A creditor should record an ALLL when the criteria for accrual of a loss contingency as set forth in GAAP have been met. Estimating the amount of an ALLL involves a high degree of management judgment and is inevitably

imprecise. GAAP requires that allowances be well documented, with clear explanations of the supporting analyses and rationale.

Who is responsible for the ALLL?

11.02 The responsibility for the ALLL policy is shared between the board, management and the supervisory committee.

The Board's Responsibility. Boards of directors of federally-insured credit unions are responsible for ensuring that their credit unions have controls in place to consistently determine the ALLL in accordance with the credit union's stated policies and procedures, GAAP, and ALLL supervisory guidance. To fulfill this responsibility, boards of directors instruct management to develop and maintain an appropriate, systematic, and consistently applied process to determine the amounts of the ALLL and provisions for loan losses. The amounts to be reported each period for the provision for loan and lease losses and the ALLL should be reviewed and approved by the board of directors.

Management's Responsibility. The determination of the amounts of the ALLL and provisions for loan and lease losses should be based on management's current judgments about the credit quality of the loan portfolio, and should consider all known relevant internal and external factors that affect loan collectibility as of the reporting date. Management should create and implement suitable policies and procedures to communicate the ALLL process internally to all applicable personnel.

Regardless of who develops and implements these policies, procedures, and the underlying controls, the board of directors should assure themselves that the policies specifically address the credit union's unique goals, systems, risk profile, personnel, and other resources before approving them. Additionally, by creating an environment that encourages personnel to follow these policies and procedures, management improves procedural discipline and compliance.

Supervisory Committee's Responsibility. To ensure the methodology remains appropriate for the credit union, the board of directors should have the methodology periodically validated and, if appropriate, revised. Further, the supervisory or audit committee¹ (or its delegated representative(s)) should oversee and monitor the

¹ All federal credit unions must establish a supervisory committee. If a federally insured state chartered credit union does not have either a supervisory or audit committee, the board of directors retains this responsibility.

internal controls over the ALLL determination process.

The validation process is discussed in greater detail in the last two sections of this chapter.

In our role of validating the methodology, would you clarify what you mean by “methodology”?

11.03 An ALLL methodology is a system that a credit union designs and implements to reasonably estimate loan and lease losses as of the financial statement date. It is critical that ALLL methodologies incorporate management’s current judgments about the credit quality of the loan portfolio through a disciplined and consistently applied process.

A credit union’s ALLL methodology is influenced by credit union-specific factors, such as a credit union’s size, organizational structure, business environment and strategy, management style, loan portfolio characteristics, loan administration procedures, and management information systems. However, there are certain common elements a credit union should incorporate in its ALLL methodology.

What are these “common elements” an ALLL methodology should have?

11.04 While different credit unions may use different methods, there are certain common elements that should be included in any loan loss allowance methodology. Generally, a credit union’s methodology should:

1. Include a detailed analysis of the loan portfolio, performed on a regular basis;
 2. Consider all loans (whether on an individual or group basis);
 3. Identify large balance, non-homogeneous loans to be evaluated for impairment on an individual basis under FAS 114 (see paragraph 11.08) and segment the remainder of the portfolio into groups of loans with similar risk characteristics for evaluation and analysis under FAS 5;
 4. Consider all known relevant internal and external factors that may affect loan collectibility;
 5. Be applied consistently but, when appropriate, be modified for new factors affecting collectibility;
 6. Consider the particular risks inherent in different kinds of lending;
 7. Consider current collateral values (less costs to sell), where applicable;
-

8. Require that analyses, estimates, reviews and other ALLL methodology functions be performed by competent and well-trained personnel;
9. Be based on current and reliable data;
10. Be well documented with clear explanations of the supporting analyses and rationale; and
11. Include a systematic and logical method to consolidate the loss estimates and ensure the ALLL balance is recorded in accordance with GAAP.

A systematic methodology that is properly designed and implemented should result in a credit union's best estimate of the ALLL. Accordingly, credit unions should adjust their ALLL balance, either upward or downward, in each period for differences between the results of the systematic determination process and the unadjusted ALLL balance in the general ledger.

In our role of overseeing and monitoring internal controls over the ALLL process, what should we focus on?

11.05 An internal control system for the ALLL estimation process should:

- (1) Include measures to ensure the reliability and integrity of information and compliance with laws, regulations, and internal policies and procedures;
 - (2) Reasonably ensure that the credit union's financial statements (including regulatory reports) are prepared in accordance with GAAP and ALLL supervisory guidance; and
 - (3) Include a well-defined loan review process containing:
 - (a) An effective loan grading system that is consistently applied, identifies differing risk characteristics and loan quality problems accurately and in a timely manner, and prompts appropriate administrative actions;
 - (b) Sufficient internal controls to ensure that all relevant loan review information is appropriately considered in estimating losses. This includes maintaining appropriate reports, details of reviews performed, and identification of personnel involved; and
 - (c) Clear formal communication and coordination between a credit union's credit administration function, financial
-

reporting group, management, board of directors, and others who are involved in the ALLL determination process or review process, as applicable (e.g., written policies and procedures, management reports, audit programs, and committee minutes).

What sorts of ALLL policies and procedures should we expect to find?

11.06 Credit unions use a wide range of policies, procedures, and control systems in their ALLL process. Sound policies should be appropriately tailored to the size and complexity of the credit union and its loan portfolio. In order for a credit union's ALLL methodology to be effective, the credit union's written policies and procedures for the systems and controls that maintain an appropriate ALLL should address but not be limited to:

- (1) The roles and responsibilities of the credit union's departments and personnel (including the lending function, credit review, financial reporting, internal audit, senior management, audit committee, board of directors, and others, as applicable) who determine, or review, as applicable, the ALLL to be reported in the financial statements;
- (2) The credit union's accounting policies for loans and loan losses, including the policies for charge-offs and recoveries and for estimating the fair value of collateral, where applicable;
- (3) The description of the credit union's systematic methodology, which should be consistent with the credit union's accounting policies for determining its ALLL; and
- (4) The system of internal controls used to ensure that the ALLL process is maintained in accordance with GAAP and supervisory guidance.

Could you elaborate on the rules that govern establishing an ALLL?

11.07 Generally accepted accounting principles (GAAP) govern establishing the ALLL. Generally, the most relevant GAAP references include:

- Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5), which provides the basic guidance for recognition of a loss contingency, such as the collectibility of loans (receivables), when it is probable that a loss has been incurred and the amount can be reasonably estimated.
-

- Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114) which provides more specific guidance about the measurement and disclosure of impairment for certain types of loans.² Specifically, FAS 114 applies to loans that are identified for evaluation on an individual basis. Loans are considered impaired when, based on current information and events, it is probable that the creditor will be unable to collect all interest and principal payments due according to the contractual terms of the loan agreement.

Other GAAP guidance includes:

- FIN 14, Reasonable Estimation
 - AICPA Audit & Accounting Guides
 - FASB Viewpoints – EITF Topic D-80
-

Could you expand on the requirements in relation to the ALLL under FAS 114?

11.08 Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment are not included in the scope of FAS 114.³ Such groups of loans may include, but are not limited to, credit card, residential mortgage, and consumer installment loans. FAS 5 addresses the accounting for impairment of these loans (see next question).

For individually impaired loans, FAS 114 provides guidance on the acceptable methods to measure impairment. Specifically, FAS 114 states that when a loan is impaired, a creditor should measure impairment based on the present value of expected future principal and interest cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price or the fair value of collateral, if the loan is collateral dependent. When developing the estimate of expected future cash flows for a loan, a credit union should consider all available information reflecting past events and current conditions, including the effect of existing environmental factors.

A credit union's ALLL methodology related to FAS 114 loans begins with the use of its normal loan review procedures to identify

²Emerging Issues Taskforce (EITF) Topic D-80 includes additional guidance on the requirements of FAS 5 and FAS 114 and how they relate to each other. The AICPA is currently developing a Statement of Position (SOP) that will provide more specific guidance on accounting for loan losses.

³ In addition, FAS 114 does not apply to loans measured at fair value or at the lower of cost or fair value, leases, or debt securities.

whether a loan is impaired as defined by the accounting standard.

Credit unions should document:

- (1) The method and process for identifying loans to be evaluated under FAS 114 and
- (2) The analysis that resulted in an impairment decision for each loan and the determination of the impairment measurement method to be used (i.e., present value of expected future cash flows, fair value of collateral less costs to sell, or the loan's observable market price).

Once a credit union has determined which of the three available measurement methods to use for an impaired loan under FAS 114, it should maintain supporting documentation as follows:

- (1) When using the present value of expected future cash flows method:
 - (a) The amount and timing of cash flows,
 - (b) The effective interest rate used to discount the cash flows, and
 - (c) The basis for the determination of cash flows, including consideration of current environmental factors and other information reflecting past events and current conditions.
- (2) When using the fair value of collateral method:
 - (a) How fair value was determined, including the use of appraisals, valuation assumptions, and calculations,
 - (b) The supporting rationale for adjustments to appraised values, if any,
 - (c) The determination of costs to sell, if applicable, and
 - (d) Appraisal quality, and the expertise and independence of the appraiser.
- (3) When using the observable market price of a loan method:
 - (a) The amount, source, and date of the observable market price.

Q&A #1 and #2 in Appendix A provide examples of applying and documenting impairment measurement methods under FAS 114.

Some loans that are evaluated individually for impairment under FAS 114 may be fully collateralized and therefore require no ALLL. Q&A #3 in Appendix A presents an example of a credit union whose loan portfolio includes fully collateralized loans and describes the documentation maintained by that credit union to support its conclusion that no ALLL was needed for those loans.

Could you expand on the requirements in relation to the ALLL under FAS 5?

11.09 Segmenting the Portfolio. For loans evaluated on a group basis under FAS 5, management should segment the loan portfolio by identifying risk characteristics that are common to groups of loans. Credit unions typically decide how to segment their loan portfolios based on many factors, which vary with their business strategies as well as their information system capabilities. Smaller credit unions that are involved in less complex activities often segment the portfolio into broad loan categories. This method of segmenting the portfolio is likely to be appropriate only in small credit unions offering a narrow range of loan products. Larger credit unions typically offer a more diverse and complex mix of loan products. Such credit unions may start by segmenting the portfolio into major loan types but typically have more detailed information available that allows them to further segregate the portfolio into product line segments based on the risk characteristics of each portfolio segment. Regardless of the segmentation method used, a credit union should maintain documentation to support its conclusion that the loans in each segment have similar attributes or characteristics.

As economic and other business conditions change, credit unions often modify their business strategies, which may result in adjustments to the way in which they segment their loan portfolio for purposes of estimating loan losses.

Credit unions use a variety of documents to support the segmentation of their portfolios.

Some of these documents include:

- Loan trial balances by categories and types of loans,
 - Management reports about the mix of loans in the portfolio,
 - Delinquency and nonaccrual reports, and
 - A summary presentation of the results of an internal or external loan grading review.
-

Reports generated to assess the profitability of a loan product line may be useful in identifying areas in which to further segment the portfolio.

Estimating Loss on Groups of Loans. Based on the segmentation of the portfolio, a credit union should estimate the FAS 5 portion of the ALLL. For those segments that require an ALLL,⁴ the credit union should estimate the loan and lease losses, on at least a quarterly basis, based upon its ongoing loan review process and analysis of loan performance. The credit union should follow a systematic and consistently applied approach to select the most appropriate loss measurement methods and support its conclusions and rationale with written documentation. Regardless of the method used to measure losses, a credit union should demonstrate and document that the loss measurement methods used to estimate the ALLL for each segment are determined in accordance with GAAP as of the financial statement date.

One method of estimating loan losses for groups of loans is through the application of loss rates to the groups' aggregate loan balances. Such loss rates typically reflect historical loan loss experience for each group of loans, adjusted for relevant environmental factors (e.g., industry, geographical, economic, and political factors) over a defined period of time. If a credit union does not have loss experience of its own, it may be appropriate to reference the loss experience of other credit unions, provided that the credit union demonstrates that the attributes of the loans in its portfolio segment are similar to those of the loans included in the portfolio of the credit union providing the loss experience.⁵ Credit unions should maintain supporting documentation for the technique used to develop their loss rates, including the period of time over which the losses were incurred. If a range of loss is determined, credit unions should maintain documentation to support the identified range and the rationale used for determining which estimate is the best estimate within the range of loan losses.

Before employing a loss estimation model, a credit union should evaluate and modify, as needed, the model's assumptions to ensure that the resulting loss estimate is consistent with GAAP. In order to demonstrate consistency with GAAP, credit unions that use loss estimation models typically document the evaluation, the conclusions regarding the appropriateness of estimating loan

⁴ An example of a loan segment that does not generally require an ALLL is loans that are fully secured by deposits maintained at the lending credit union.

⁵ Refer to paragraph 23 of FAS 5.

losses with a model or other loss estimation tool, and the support for adjustments to the model or its results.

In developing loss measurements, credit unions should consider the impact of current environmental factors and then document which factors were used in the analysis and how those factors affect the loss measurements. Factors that should be considered in developing loss measurements include the following:

- (1) Levels of and trends in delinquencies and impaired loans;
- (2) Levels of and trends in charge-offs and recoveries;
- (3) Trends in volume and terms of loans;
- (4) Effects of any changes in risk selection and underwriting standards, and other changes in lending policies, procedures, and practices;
- (5) Experience, ability, and depth of lending management and other relevant staff;
- (6) National and local economic trends and conditions;
- (7) Industry conditions; and
- (8) Effects of changes in credit concentrations.

For any adjustment of loss measurements for environmental factors, the credit union should maintain sufficient, objective evidence to support the amount of the adjustment and to explain why the adjustment is necessary to reflect current information, events, circumstances, and conditions in the loss measurements.

Q&A #4 in Appendix A provides an example of maintaining supporting documentation for adjustments to portfolio segment loss rates for an environmental factor related to an economic downturn in the borrower's primary industry. Q&A #5 in Appendix A describes one credit union's process for determining and documenting an ALLL for loans that are not individually impaired but have characteristics indicating there are loan losses on a group basis.

Layering Loan Losses. Credit unions should ensure that they do not layer their loan loss allowances. Layering is the inappropriate practice of recording in the ALLL more than one amount for the same probable loan loss. Layering can happen when a credit union includes a loan in one segment, determines its best estimate

of loss for that loan either individually or on a group basis (after taking into account all appropriate environmental factors, conditions, and events), and then includes the loan in another group, which receives an additional ALLL amount.⁶

What documentation standards should the credit union meet?

11.10 Appropriate written supporting documentation facilitates review of the ALLL process and reported amounts, builds discipline and consistency into the ALLL determination process, and improves the process for estimating loan and lease losses by helping to ensure that all relevant factors are appropriately considered in the ALLL analysis. A credit union should document the relationship between the findings of its detailed review of the loan portfolio and the amount of the ALLL and the provision for loan and lease losses reported in each period.

At a minimum, credit unions should maintain written supporting documentation for the following decisions, strategies, and processes:

1. Policies and procedures:
 - a. Over the systems and controls that maintain an appropriate ALLL, and
 - b. Over the ALLL methodology,
2. Loan grading system or process,
3. Summary or consolidation of the ALLL balance,
4. Validation of the ALLL methodology, and
5. Periodic adjustments to the ALLL process.

Could you be more specific concerning the documentation of ALLL methodology in written policies and procedures?

11.11 A credit union's written policies and procedures should describe the primary elements of the credit union's ALLL methodology, including portfolio segmentation and impairment measurement. In order for a credit union's ALLL methodology to be effective, the credit union's written policies and procedures should describe the methodology:

⁶ According to the Federal Financial Institutions Examination Council's Federal Register Notice, *Implementation Issues Arising from FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan*, published February 10, 1995, institution-specific issues should be reviewed when estimating loan losses under FAS 114. This analysis should be conducted as part of the evaluation of each individual loan reviewed under FAS 114 to avoid potential ALLL layering.

- (1) For segmenting the portfolio:
 - (a) How the segmentation process is performed (i.e., by loan type, industry, risk rates, etc.),
 - (b) When a loan grading system is used to segment the portfolio:
 - (i) The definitions of each loan grade,
 - (ii) A reconciliation of the internal loan grades to supervisory loan grades, and
 - (iii) The delineation of responsibilities for the loan grading system.

 - (2) For determining and measuring impairment under FAS 114:
 - (a) The methods used to identify loans to be analyzed individually;
 - (b) For individually reviewed loans that are impaired, how the amount of any impairment is determined and measured, including:
 - (i) Procedures describing the impairment measurement techniques available and
 - (ii) Steps performed to determine which technique is most appropriate in a given situation.
 - (c) The methods used to determine whether and how loans individually evaluated under FAS 114, but not considered to be individually impaired, should be grouped with other loans that share common characteristics for impairment evaluation under FAS 5.

 - (3) For determining and measuring impairment under FAS 5:
 - (a) How loans with similar characteristics are grouped to be evaluated for loan collectibility (such as loan type, past-due status, and risk);
 - (b) How loss rates are determined (e.g., historical loss rates adjusted for environmental factors or migration analysis) and what factors are considered when establishing appropriate time frames over which to evaluate loss experience; and
 - (c) Descriptions of qualitative factors (e.g., industry, geographical, economic and political factors) that may affect loss rates or other loss measurements.
-

The supporting documents for the ALLL may be integrated in a credit union's credit files, loan review reports or worksheets, board of directors' and committee meeting minutes, computer reports, or other appropriate documents and files.

Is there a lesser documentation burden for small credit unions?

11.12 While the guidance applies equally to all credit unions, regardless of the size, it recognizes operational and managerial standards that are appropriate for a credit union's size and the nature and scope of its activities. For example, credit unions with less complex lending activities and products may find it more efficient to combine a number of procedures (e.g., information gathering, documentation, and internal approval processes) while continuing to ensure the credit union has a consistent and appropriate methodology.

Thus, much of the supporting documentation required for a credit union with more complex products or portfolios may be combined into fewer supporting documents in a credit union with less complex products or portfolios. As a further example, simplified documentation can include spreadsheets, check lists, and other summary documents that many credit unions currently use.

Could you provide some guidance on the process of consolidating the loss estimates?

11.13 To verify that ALLL balances are presented fairly in accordance with GAAP and are auditable, management should prepare a document that summarizes the amount to be reported in the financial statements for the ALLL. The board of directors should review and approve this summary.

Common elements in such summaries include:

- (1) An estimate of the probable loss or range of loss incurred for each category evaluated (e.g., individually evaluated impaired loans, homogeneous pools, and other groups of loans that are collectively evaluated for impairment);
 - (2) The aggregate probable loss estimated using the credit union's methodology;
 - (3) A summary of the current ALLL balance;
-

(4) The amount, if any, by which the ALLL is to be adjusted;⁷ and

(5) Depending on the level of detail that supports the ALLL analysis, detailed sub-schedules of loss estimates that reconcile to the summary schedule.

Generally, a credit union's review and approval process for the ALLL relies upon the data provided in these consolidated summaries.

There may be instances in which individuals or committees that review the ALLL methodology and resulting allowance balance identify adjustments that need to be made to the loss estimates to provide a better estimate of loan losses. These changes may be due to information not known at the time of the initial loss estimate (e.g., information that surfaces after determining and adjusting, as necessary, historical loss rates, or a recent decline in the marketability of property after conducting a FAS 114 valuation based upon the fair value of collateral).

It is important that these adjustments are consistent with GAAP and are reviewed and approved by appropriate personnel. Additionally, the summary should provide each subsequent reviewer with an understanding of the support behind these adjustments. Therefore, management should document the nature of any adjustments and the underlying rationale for making the changes. This documentation should be provided to those making the final determination of the ALLL amount. Q&A #6 in Appendix A addresses the documentation of the final amount of the ALLL.

What should we focus on in validating the ALLL methodology?

11.14 A credit union's ALLL methodology is considered valid when it accurately estimates the amount of loss contained in the portfolio. Thus, the credit union's methodology should include procedures that adjust loss estimation methods to reduce differences between estimated losses and actual subsequent charge-offs, as necessary.

⁷ Subsequent to adjustments, there should be no material differences between the consolidated loss estimate, as determined by the methodology, and the final ALLL balance reported in the financial statements.

To verify that the ALLL methodology is valid and conforms to GAAP and supervisory guidance, a credit union's directors should establish internal control policies, appropriate for the size of the credit union and the type and complexity of its loan products. These policies should include procedures for a review, by a party who is independent of the ALLL estimation process, of the ALLL methodology and its application in order to confirm its effectiveness.

In practice, credit unions employ numerous procedures when validating the reasonableness of their ALLL methodology and determining whether there may be deficiencies in their overall methodology or loan grading process. Examples are:

- (1) A review of trends in loan volume, delinquencies, restructurings, and concentrations.
- (2) A review of previous charge-off and recovery history, including an evaluation of the timeliness of the entries to record both the charge-offs and the recoveries.
- (3) A review by a party that is independent of the ALLL estimation process. This often involves the independent party reviewing, on a test basis, source documents and underlying assumptions to determine that the established methodology develops reasonable loss estimates.
- (4) An evaluation of the appraisal process of the underlying collateral. This may be accomplished by periodically comparing the appraised value to the actual sales price on selected properties sold.

What documentation do we need to support the validation process?

11.15 Management usually supports the validation process with the workpapers from the ALLL review function. Additional documentation often includes the summary findings of the independent reviewer. The credit union's board of directors, or its designee, reviews the findings and acknowledges its review in its meeting minutes. If the methodology is changed based upon the findings of the validation process, documentation that describes and supports the changes should be maintained.

APPENDIX A – ALLL QUESTIONS AND ANSWERS

Introduction

The Questions and Answers (Q&As) presented in this appendix serve several purposes, including (1) to illustrate the NCUA's views, as set forth in this IRPS, about the types of decisions, determinations, and processes a credit union should document with respect to its ALLL methodology and amounts; and (2) to illustrate the types of ALLL documentation and processes a credit union might prepare, retain, or use in a particular set of circumstances. The level and types of documentation described in the Q&As should be considered neither the minimum acceptable level of documentation nor an all-inclusive list. Credit unions are expected to apply the guidance in this IRPS to their individual facts, circumstances, and situations. If a credit union's fact pattern differs from the fact patterns incorporated in the following Q&As, the credit union may decide to prepare and maintain different types of documentation than did the credit unions depicted in these Q&As.

Q&A #1 - ALLL Under FAS 114 – Measuring and Documenting Impairment

Facts: Approximately one-third of Credit Union A's business loan portfolio consists of large balance, non-homogeneous loans. Due to their large individual balances, these loans meet the criteria under Credit Union A's policies and procedures for individual review for impairment under FAS 114. Upon review of the large balance loans, Credit Union A determines that certain of the loans are impaired as defined by FAS 114.

Question: For the business loans reviewed under FAS 114 that are individually impaired, how should Credit Union A measure and document the impairment on those loans? Can it use an impairment measurement method other than the methods allowed by FAS 114?

Interpretive Response: For those loans that are reviewed individually under FAS 114 and considered individually impaired, Credit Union A must use one of the methods for measuring impairment that is specified by FAS 114 (that is, the present value of expected future cash flows, the loan's observable market price, or the fair value of collateral). Accordingly, in the circumstances described above, for the loans considered individually impaired under FAS 114, it would not be appropriate for Credit Union A to choose a measurement method not prescribed by FAS 114. For example, it would not be appropriate to measure loan impairment by applying a loss rate to each loan based on the average historical loss percentage for all of its business loans for the past five years.

Credit Union A should maintain, as sufficient, objective evidence, written documentation to support its measurement of loan impairment under FAS 114. If Credit Union A uses the present value of expected future cash flows to measure impairment of a loan, it should document the amount and timing of cash flows, the effective interest rate used to discount the cash flows, and the basis for the determination of cash flows, including consideration of current environmental factors¹ and other information reflecting past events and current

¹ Question #16 in Exhibit D-80A of EITF Topic D-80 and attachments indicates that environmental factors include existing industry, geographical, economic, and political factors.

conditions. When Credit Union A uses the fair value of collateral to measure impairment, Credit Union A should document how it determined the fair value, including the use of appraisals, valuation assumptions and calculations, the supporting rationale for adjustments to appraised values, if any, and the determination of costs to sell, if applicable, appraisal quality, and the expertise and independence of the appraiser. Similarly, Credit Union A should document the amount, source, and date of the observable market price of a loan, if that method of measuring loan impairment is used.

Q&A #2 – ALLL Under FAS 114 – Measuring Impairment for a Collateral Dependent Loan

Facts: Credit Union B has a \$10 million loan outstanding to Member X that is secured by real estate, which Credit Union B individually evaluates under FAS 114 due to the loan's size. Member X is delinquent in its loan payments under the terms of the loan agreement. Accordingly, Credit Union B determines that its loan to Member X is impaired, as defined by FAS 114. Because the loan is collateral dependent, Credit Union B measures impairment of the loan based on the fair value of the collateral. Credit Union B determines that the most recent valuation of the collateral was performed by an appraiser eighteen months ago and, at that time, the estimated value of the collateral (fair value less costs to sell) was \$12 million.

Credit Union B believes that certain of the assumptions that were used to value the collateral eighteen months ago do not reflect current market conditions and, therefore, the appraiser's valuation does not approximate current fair value of the collateral. Several buildings, which are comparable to the real estate collateral, were recently completed in the area, increasing vacancy rates, decreasing lease rates, and attracting several tenants away from the borrower. Accordingly, credit review personnel at Credit Union B adjust certain of the valuation assumptions to better reflect the current market conditions as they relate to the loan's collateral.² After adjusting the collateral valuation assumptions, the credit review department determines that the current estimated fair value of the collateral, less costs to sell, is \$8 million. Given that the recorded investment in the loan is \$10 million, Credit Union B concludes that the loan is impaired by \$2 million and records an allowance for loan losses of \$2 million.

Question: What type of documentation should Credit Union B maintain to support its determination of the allowance for loan losses of \$2 million for the loan to Member X?

Interpretive Response: Credit Union B should document that it measured impairment of the loan to Member X by using the fair value of the loan's collateral, less costs to sell, which it estimated to be \$8 million. This documentation should include the credit union's rationale and basis for the \$8 million valuation, including the revised valuation assumptions it used, the valuation calculation, and the determination of costs to sell, if applicable. Because Credit Union B arrived at the valuation of \$8 million by modifying an earlier appraisal, it should document its rationale and basis for the changes it made to the valuation

² When reviewing collateral dependent loans, Credit Union B may often find it more appropriate to obtain an updated appraisal to estimate the effect of current market conditions on the appraised value instead of internally estimating an adjustment.

assumptions that resulted in the collateral value declining from \$12 million eighteen months ago to \$8 million in the current period.³

Q&A #3 – ALLL Under FAS 114 – Fully Collateralized Loans

Facts: Credit Union C has \$500,000 in business loans that are fully collateralized by purchased business equipment. The loan agreement for each of these loans requires the borrower to provide qualifying collateral sufficient to fully secure each loan. The member borrowers have physical control of the collateral. Credit Union C perfected its security interest in the collateral when the funds were originally distributed. On an annual basis, Credit Union C determines the market value of the collateral for each loan using two independent market quotes and compares the collateral value to the loan carrying value. Semiannually or more frequently as needed, the Credit Union C's credit administration function physically inspects the equipment. If there are any collateral deficiencies, Credit Union C notifies the borrower and requests that the borrower immediately remedy the deficiency. Due in part to its efficient operation, Credit Union C has historically not incurred any material losses on these loans. Credit Union C believes these loans are fully-collateralized and therefore does not maintain any ALLL balance for these loans.

Question: What documentation does Credit Union C maintain to adequately support its determination that no allowance is needed for this group of loans?

Interpretive Response: Credit Union C's management summary of the ALLL includes documentation indicating that, in accordance with the credit union's ALLL policy, the collateral protection on these loans has been verified by the credit union, no probable loss has been incurred, and no ALLL is necessary. Documentation in Credit Union C's loan files includes the two independent market quotes obtained annually for each loan's collateral amount, the documents evidencing the perfection of the security interest in the collateral, and other relevant supporting documents. Additionally, Credit Union C's ALLL policy includes a discussion of how to determine when a loan is considered "fully collateralized" and does not require an ALLL. Credit Union C's policy requires the following factors to be considered and the credit union's findings concerning these factors to be fully documented:

1. Volatility of the market value of the collateral;
2. Recency and reliability of the appraisal or other valuation;
3. Recency of the credit union or other third party inspection of the collateral;
4. Historical losses on similar loans;
5. Confidence in the credit union's lien or security position including appropriate:
 - a. Type of security perfection (e.g., physical possession of collateral or secured filing);
 - b. Filing of security perfection (i.e., correct documents and with the appropriate officials); and

³In accordance with the FFIEC's **Federal Register** Notice, Implementation Issues Arising from FASB No. 114, "Accounting by Creditors for Impairment of a Loan," published February 10, 1995 (60 FR 7966, February 10, 1995), impaired, collateral-dependent loans must be reported at the fair value of collateral, less costs to sell, in regulatory reports. This treatment is to be applied to all collateral-dependent loans, regardless of type of collateral.

- c. Relationship to other liens.
- 6. Other factors as appropriate for the loan type

Q&A #4 – ALLL Under FAS 5 – Adjusting Loss Rates

Facts: Credit Union D's field of membership (lending area) includes a metropolitan area that is financially dependent upon the profitability of a number of sponsor manufacturing businesses. These businesses use highly specialized equipment and significant quantities of rare metals in the manufacturing process. Due to increased low-cost foreign competition, several of the parts suppliers servicing these sponsor manufacturing firms declared bankruptcy. The foreign suppliers have subsequently increased prices and the sponsor manufacturing firms have suffered from increased equipment maintenance costs and smaller profit margins. Additionally, the cost of the rare metals used in the manufacturing process increased and has now stabilized at double last year's price. Due to these events, the sponsor manufacturing businesses are experiencing financial difficulties and have recently announced downsizing plans.

Although Credit Union D has yet to confirm an increase in its loss experience as a result of these events, management knows that the credit union lends to a significant number of member's for business and individual purposes whose repayment ability depends upon the long-term viability of the sponsor manufacturing businesses. Credit Union D's management has identified particular segments of its business and consumer member bases that include member borrowers highly dependent upon sales or salary from the sponsor manufacturing businesses. Credit Union D's management performs an analysis of the affected portfolio segments to adjust its historical loss rates used to determine the ALLL. In this particular case, Credit Union D has experienced similar business and lending conditions in the past that it can compare to current conditions.

Question: How should Credit Union D document its support for the loss rate adjustments that result from considering these manufacturing firms' financial downturns?

Interpretive Response: Credit Union D should document its identification of the particular segments of its business and consumer loan portfolio for which it is probable that the sponsor manufacturing business' financial downturn has resulted in loan losses. In addition, Credit Union D should document its analysis that resulted in the adjustments to the loss rates for the affected portfolio segments. As part of its documentation, Credit Union D maintains copies of the documents supporting the analysis, including relevant newspaper articles, economic reports, and economic data, and notes from discussions with individual member borrowers.

Because in this case Credit Union D has had similar situations in the past, its supporting documentation also includes an analysis of how the current conditions compare to its previous loss experiences in similar circumstances. As part of its effective ALLL methodology, Credit Union D creates a summary of the amount and rationale for the adjustment factor, which management presents to the audit committee and board for their review and approval prior to the issuance of the financial statements.

Q&A #5 – ALLL Under FAS 5 – Estimating Losses on Loans Individually Reviewed for Impairment but Not Considered Individually Impaired

Facts: Credit Union E has outstanding loans of \$875,000 to Member Y and \$725,000 to Member Z, both of which are paying as agreed upon in the loan documents. The credit union's ALLL policy specifies that all loans greater than \$700,000 must be individually reviewed for impairment under FAS 114. Member Y's financial statements reflect a strong net worth, good profits, and ongoing ability to meet debt service requirements. In contrast, recent information indicates Member Z's profitability is declining and its cash flow is tight. Accordingly, this loan is rated substandard under the credit union's loan grading system. Despite its concern, management believes Member Z will resolve its problems and determines that neither loan is individually impaired as defined by FAS 114.

Credit Union E segments its loan portfolio to estimate loan losses under FAS 5. Two of its loan portfolio segments are Segment 1 and Segment 2. The loan to Member Y has risk characteristics similar to the loans included in Segment 1 and the loan to Member Z has risk characteristics similar to the loans included in Segment 2.⁴

In its determination of the ALLL under FAS 5, Credit Union E includes its loans to Member Y and Member Z in the groups of loans with similar characteristics (i.e., Segment 1 for Member Y's loan and Segment 2 for Member Z's loan). Management's analyses of Segment 1 and Segment 2 indicate that it is probable that each segment includes some losses, even though the losses cannot be identified to one or more specific loans. Management estimates that the use of its historical loss rates for these two segments, with adjustments for changes in environmental factors provides a reasonable estimate of the credit union's probable loan losses in these segments.

Question: How does Credit Union E adequately support and document an ALLL under FAS 5 for these loans that were individually reviewed for impairment but are not considered individually impaired?

Interpretive Response: As part of Credit Union E's effective ALLL methodology, it documents the decision to include its loans to Member Y and Member Z in its determination of its ALLL under FAS 5. It also documents the specific characteristics of the loans that were the basis for grouping these loans with other loans in Segment 1 and Segment 2, respectively. Credit Union E maintains documentation to support its method of estimating loan losses for Segment 1 and Segment 2, including the average loss rate used, the analysis of historical losses by loan type and by internal risk rating, and support for any adjustments to its historical loss rates. The credit union also maintains copies of the economic and other reports that provided source data.

Q&A #6 - Consolidating the Loss Estimates – Documenting the Reported ALLL

⁴ These groups of loans do not include any loans that have been individually reviewed for impairment under FAS 114 and determined to be impaired as defined by FAS 114.

Facts: Credit Union F determines its ALLL using an established systematic process. At the end of each period, the accounting department prepares a summary schedule that includes the amount of each of the components of the ALLL, as well as the total ALLL amount, for review by senior management, the Credit Committee, and, ultimately, the board of directors. Members of senior management and the Credit Committee meet to discuss the ALLL. During these discussions, they identify changes to be made to certain of the ALLL estimates. As a result of the adjustments made by senior management, the total amount of the ALLL changes. However, senior management (or its designee) does not update the ALLL summary schedule to reflect the adjustments or reasons for the adjustments. When performing their audit of the financial statements, the independent accountants are provided with the original ALLL summary schedule that was reviewed by management and the Credit Committee, as well as a verbal explanation of the changes made by senior management and the Credit Committee when they met to discuss the loan loss allowance.

Question: Are Credit Union F's documentation practices related to the balance of its loan loss allowance appropriate?

Interpretive Response: No. A credit union must maintain supporting documentation for the loan loss allowance amount reported in its financial statements. As illustrated above, there may be instances in which ALLL reviewers identify adjustments that need to be made to the loan loss estimates. The nature of the adjustments, how they were measured or determined, and the underlying rationale for making the changes to the ALLL balance should be documented. Appropriate documentation of the adjustments should be provided to the board of directors (or its designee) for review of the final ALLL amount to be reported in the financial statements. For credit unions subject to external audit, this documentation should also be made available to the supervisory committee and its independent accountants. If changes frequently occur during management or committee reviews of the ALLL, management may find it appropriate to analyze the reasons for the frequent changes and to reassess the methodology the credit union uses.

Appendix 11-B --“*Allowance for Loan Losses*” Workpaper

What is the purpose of this workpaper?

This workpaper relates to answering question 3 (concerning charge-offs and recoveries) on the Allowance for Loan Losses Internal Control checklist (Appendix 11-C).

By completing this workpaper, you will verify (or dispute) that the general ledger control account accurately reflects the loans charged off, recoveries on loans previously charged off, and the activity of management to maintain the account balance at a level commensurate with their computations of the amount needed for full and fair disclosure.

What do we need to get started?

Obtain a printout of the detailed monthly transactions taking place in the ALL during your audit period. The printout should have enough detail so that each entry can be identified and traced to the daily transaction activity.

What do we look for when reviewing the ALL account activity?

Each of the four columns provides information to address a specific internal control function:

- **Charge-offs:** Each entry here should be traceable to an authorization by the board of directors.
 - **Recoveries:** Payments received from loans previously charged off could be diverted into someone’s personal account. Receipts can be traced to the related recovery posting in this account to test for internal control of recoveries.
-

- **PLL Adjustment:** These entries replenish the ALL to the amount computed by management as needed for full and fair disclosure. Each ALL adjustment entry should be matched to each PLL expense entry.
 - **Miscellaneous Debits and Credits:** Rarely should you see anything in this column. Any such entry should be closely scrutinized to ensure irregularities are not being covered up by using this equity account.
-

ALLOWANCE FOR LOAN LOSSES

Credit Union:	Ex Why Zee FCU	12/31/1996	Audit date
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Transaction Month	Charge-offs	Recoveries	PLL Adjustment	Misc. (DR) and CR	Balance	Comments
Begin at date of your last audit, record monthly through the current date:					100,000.00	
JAN					100,000.00	
FEB					0.00	
MAR					0.00	
APR					100,000.00	
MAY	10,000.00	1,000.00	10,000.00		101,000.00	
JUN	10,000.00	1,000.00	10,000.00		102,000.00	
JUL	10,000.00	1,000.00	10,000.00		103,000.00	
AUG	10,000.00	1,000.00	10,000.00		104,000.00	
SEP	10,000.00	1,000.00	10,000.00		105,000.00	
OCT	10,000.00	1,000.00	10,000.00		106,000.00	
NOV	10,000.00	1,000.00	10,000.00		107,000.00	
DEC	10,000.00	1,000.00	10,000.00		108,000.00	
JAN					108,000.00	
FEB					108,000.00	
MAR					108,000.00	
APR					108,000.00	
MAY					108,000.00	
JUN					108,000.00	
JUL					108,000.00	
AUG					108,000.00	
SEP					108,000.00	
OCT					108,000.00	
NOV					108,000.00	
DEC					108,000.00	

Totals:	80,000.00	8,000.00	80,000.00	0.00	108,000.00	
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Balance of the A.L.L. (Account No. 719): 109,000.00

Difference: **(1,000.00)**

Describe actions by staff to correct difference:

NOTE: For help, refer to the workpaper discussion at the end of Chapter 11 of the SC Guide.

Appendix 11-C -- *Instructions for the Allowance for Loan and Lease Losses Checklist*

What does this checklist accomplish?

Completing this workpaper should give you a basic understanding about the control over ALLL activity by the credit union. The checklist is designed to be your primary guide for the valuation account audit.

How do we complete this checklist?

You will need to prepare a number of working papers in the process of answering some questions on the Checklist. We provide one sample workpaper in this chapter, attached as Appendix 11-B, to record and analyze activity in the ALLL over the audit period.

About halfway through the checklist, you will gain a familiarity with the credit union's system of internal controls. By the time you finish, you should be able to come to, and support, a conclusion of whether or not the ALLL represents a reasonable assessment of the loan portfolio's value.

Appendix 11-C -- Internal Controls Checklist: ALLL

File: chklst11.doc

Test	Procedure	Yes	No
1. Are policies and procedures adequate?	Review loan internal control checklist in Chapter 10. Review policies for collections and procedures for funding the ALLL. Verify that practices follow the policies. [App 10-C]	<input type="checkbox"/>	<input type="checkbox"/>
2. Is repossessed and sold loan collateral properly controlled?	Test-check monthly board minutes for approval by, or reporting to, the board of directors. Loans should be segregated into a separate GL account, and <i>not</i> removed from the monthly report of delinquent loans.	<input type="checkbox"/>	<input type="checkbox"/>
3. Are charge-offs and recoveries properly controlled?	Cross-reference approval for a sample of charge-offs to the board minutes. Minutes should also show reviews of recoveries and of the delinquent loan list.	<input type="checkbox"/>	<input type="checkbox"/>
4. Is the month-end delinquent loan list correct?	Test-check some delinquent loans to confirm the delinquent loan report shows the correct number of months past due. Verify that due dates aren't improperly advanced.	<input type="checkbox"/>	<input type="checkbox"/>
5. Is the collection program active and effective?	Test-check a sample of the collection work on delinquent loans. Compare practices with the collection policies. The records should illustrate that collection efforts are reasonably frequent and effective.	<input type="checkbox"/>	<input type="checkbox"/>
6. Are loans turned over to outside collections properly controlled?	Test-check to ensure that the loan balances are the same at the collection agencies and attorneys as at the credit union. Investigate any discrepancies.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 11-C -- Internal Controls Checklist: ALLL

File: chklst11.doc

Test	Procedure	Yes	No
7. Does management monitor loan officer and collector activity?	Review monitoring practices with management to determine if supervisors regularly review reports of key areas.	<input type="checkbox"/>	<input type="checkbox"/>
8. Is recordkeeping accurate?	Record the monthly transactions to the ALLL on a working paper, such as the sample attached to this chapter of the Guide. Reconcile to the general ledger account for the ALLL.	<input type="checkbox"/>	<input type="checkbox"/>

Chapter 12 -- HOW DO WE AUDIT FIXED ASSETS?

- 12.01 What general ledger accounts are part of the fixed asset area?**
- 12.02 What is the limit for fixed assets for a Federal Credit Union?**
- 12.03 Why are internal controls over fixed assets important?**
- 12.04 How does the supervisory committee review the internal controls over fixed assets?**
- 12.05 What are the audit objectives for fixed assets?**
- 12.06 What are the audit procedures for fixed assets?**
- 12.07 How do we review depreciation expense?**

Appendices

12-A *Internal Control Checklist: Fixed Assets.*

12-B *Sample Workpaper For Fixed Assets.*

What general ledger accounts are part of the fixed asset area?

12.01 The 770 series of accounts in the general ledger (as discussed further in the *Accounting Manual for Federal Credit Unions*) identify the fixed asset accounts used by the credit union.

Fixed asset accounts include:

- Land.
- Building.
- Furniture and equipment.
- Leasehold improvements.
- Leased assets under capital lease.
- Related allowances for depreciation.
- Allowances for amortization.

NOTE: *This Guide is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the Federal Credit Union Act and the National Credit Union Administration Rules and Regulations §715.*

What is the limit for fixed assets for a Federal Credit Union?

12.02 Federal credit unions with \$1,000,000 or more in assets are limited in fixed assets holdings to five percent of shares and retained earnings. Lease payments on fixed assets are included in this limit. Refer to §701.36 of the NCUA Rules and Regulations for detail.

Why are internal controls over fixed assets important?

12.03 Fixed assets must be adequately safeguarded to ensure that controls exist to limit the opportunity for inappropriate use of credit union assets.

How does the supervisory committee review the internal controls over fixed assets?

12.04 To review the internal controls over fixed assets, you may use the internal control check list in this *Guide*. The internal control check list is included in the Appendix.

What are the audit objectives for fixed assets?

12.05 Your objectives are to determine if:

- Internal controls are adequate.
 - Fixed asset subsidiary records are in balance with the respective general ledger account.
 - Fixed assets are properly recorded at cost and are properly capitalized.
 - Depreciation periods are reasonable and consistent with the useful life of the asset.
-

- Depreciation/amortization charged to expense is reasonable and consistent.
 - Purchases and disposals in the audit period are properly authorized and recorded.
 - Adequate insurance coverage is in place.
 - Fixed assets are properly classified on the statement of financial condition.
-

What are the audit procedures for fixed assets?

12.06 To audit fixed assets, you:

- Review the internal control checklist for fixed assets. An internal control checklist is provided in the Appendix.
 - Complete a schedule summarizing fixed asset account activity since the last audit date through the current audit date. A sample workpaper, with instructions, is provided in the Appendix to this chapter. You may use the workpaper for your review of fixed assets. The purpose of the workpaper is to summarize the account activity (purchases, disposals, and depreciation). Alternatively, you may obtain and use the general ledger account history for fixed assets and depreciation expense (copies should be retained for your workpapers).
 - Review original invoices for significant fixed asset purchases. Most credit unions maintain a file for fixed asset invoices. Obtain the invoice file. Trace significant purchases to the original invoice to determine if the item is recorded at original cost. The invoice should be reviewed to determine if the item purchased is a tangible asset which must be capitalized. Costs which may not be capitalized are routine repairs and maintenance expenses.
-

- Determine if significant fixed assets purchased are on site at the credit union. This is accomplished by completing a physical inventory of significant fixed assets. The inventory should be completed to verify major acquisitions.
 - Review board approval in the minutes for significant fixed asset purchases and disposals. Board approval should be documented in the minutes for major dollar amount purchases. The same is true for disposals (sales or discard).
 - Review depreciation expense recorded in the audit period. Refer to section 12.07 in this Chapter.
 - Test depreciation calculations for reasonableness and consistency with the useful life of the asset. Refer to section 12.07 in this Chapter.
 - Determine if the total amount of fixed assets complies with the NCUA Fixed Asset Regulation, §701.36. If management has exceeded this limit, management must prepare a fixed asset waiver for submission to and approval by the NCUA regional director, prior to exceeding the limit discussed in paragraph 12.02 in this Chapter.
 - Determine if insurance coverage is adequate for fixed assets. Obtain the insurance policy. Compare the net book value for each classification of fixed assets with the insurance coverage amount on the policy. At a minimum, fixed assets should be insured for the net book value (original cost less accumulated depreciation). Insuring fixed assets for replacement value is something to consider for major assets, such as the building and computer equipment.
 - Determine if fixed assets are accurately reported on the statement of financial condition. This is accomplished by tracing the accounts and balances reported on the general ledger trial balance, to the statement of financial condition.
-

How do we review depreciation expense?

12.07 Depreciation expense accounts are usually identified by the following general ledger account numbers:

- G.L. #254 - Depreciation - Building.
- G.L. #255 - Amortization of Leasehold Improvements.
- G.L. #257 - Depreciation Expense for Leased Assets.
- G.L. #266 - Depreciation of Furniture and Equipment.

You review the general ledger account history for the depreciation expense accounts. Assess whether or not depreciation expense is consistently applied. For example, most credit unions record depreciation expense monthly; therefore, depreciation expense should be recorded in the general ledger each month.

If significant fluctuations are noted, expand your review to determine the reasons why depreciation expense is not consistently recorded.

Common Depreciation Method. Most credit unions depreciate fixed assets using the “straight line” method.

An example of the “straight line” method is:

A computer is purchased for \$4,200 and management has selected a depreciation term of 36 months. Salvage value (SV) is estimated at \$600.

The depreciation expense is determined by dividing the cost of the computer less SV by the number of months in the depreciation term:

$$\$ (4,200 - 600) / 36 \text{ months} = \$100 \text{ per month.}$$

Depreciation Terms. Fixed assets are required to be depreciated *over their useful lives*. Leasehold improvements are required to be amortized over the term of the lease.

Appendix 12-A -- *Internal Control Checklist: Fixed Assets*

The following checklist should help you identify significant internal control and operating weaknesses, if any. You may find additional guidance in the AICPA's "*Audits of Credit Unions*" and/or the AICPA's "*Credit Union Audit Manual*."

Test	Procedure	Yes	No
1. Are fixed asset subsidiary records in balance with the respective general ledger accounts?	Compare audit date totals on the subsidiary records with the audit date general ledger totals.	<input type="checkbox"/>	<input type="checkbox"/>
2. Is an annual fixed asset inventory completed by an individual who is not involved in fixed asset accounting?	Determine if an employee, not involved with fixed asset accounting, or a supervisory committee member completes a fixed asset inventory to ensure that all fixed assets on the credit union books are on site in the credit union.	<input type="checkbox"/>	<input type="checkbox"/>
3. Is a reasonable depreciation term policy in place?	Verify that a written board approved policy addresses guidelines for fixed asset depreciation terms.	<input type="checkbox"/>	<input type="checkbox"/>
4. Is a dollar policy limit in place to authorize management to purchase fixed assets?	Verify that the board has an approved policy limit which allows management to purchase a fixed asset below a certain dollar amount without board approval.	<input type="checkbox"/>	<input type="checkbox"/>
5. Is board of director approval required for fixed asset purchases above a certain dollar amount?	Verify that fixed asset purchases above a certain dollar amount requires board approval to control large purchases and expenditures.	<input type="checkbox"/>	<input type="checkbox"/>
6. Are original sales invoices maintained to document the cost basis of the asset?	Review original sales invoices to document the purchase price of the fixed asset.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 12-A -- Internal Control Checklist: Fixed Assets

Test	Procedure	Yes	No
7. Is fixed asset insurance coverage adequate?	Review the amount of insurance coverage in relation to the net book value and/or the replacement cost for computer equipment, furniture and equipment, and building, if applicable.	<input type="checkbox"/>	<input type="checkbox"/>
8. Are vehicles, land, and building (if applicable) titled in the name of the credit union?	Review the title for applicable assets which document ownership interest with a title. Ensure that the credit union is listed as the owner on the title.	<input type="checkbox"/>	<input type="checkbox"/>
9. Are competitive bids requested and reviewed before making a significant purchase?	Determine if significant purchases are made through a competitive bidding process. It is a sound business practice to require a minimum of three bids before making a large dollar fixed asset purchase.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 12-B -- *Instructions for Fixed Asset Workpaper*

How do you complete the sample work paper provided for fixed assets?

You complete the following steps:

- a) List the general account number for the accounts audited in column 1.
 - b) List the date management purchased the fixed asset in column 2. You obtain the purchase date from the general ledger account history.
 - c) List the cost of the fixed asset in column 3. You obtain the cost of a fixed asset purchase by reviewing the debit entries on the fixed asset general ledger account history.
 - d) List a brief description of the fixed asset purchased in column 4.
 - e) List the depreciation term in months in column 5. Determine if the depreciation term is reasonable. Refer to the *Accounting Manual for Federal Credit Unions*, fixed asset section, if you need additional information for depreciation term guidelines.
 - f) Review the original invoice for the fixed asset purchased. Enter a "Y" for yes in column 6 after you complete this.
 - g) If the fixed asset item purchased is a significant item for your credit union, verify in the board meeting minutes that the board approved this item. Enter a "Y" for yes to document board approval, or a "N/A" for not applicable if the item was not a significant dollar amount purchase.
 - h) If the acquired fixed asset is significant, determine if the fixed asset is on hand at the credit union. If you verify that the fixed asset is on hand at the credit union, enter a "Y" for yes in the column. You don't need to complete this procedure for items purchased for a relatively small dollar amount.
-

Chapter 13 -- *HOW DO WE AUDIT "OTHER ASSETS"?*

- 13.01 What general ledger accounts are part of the "*Other Assets*" account group?
- 13.02 How do we review the internal controls over "*Other Assets*"?
- 13.03 What are the audit objectives for "*Other Assets*"?
- 13.04 What are the audit procedures for "*Other Assets*"?

Appendices

- 13-A *Internal control checklist: Other Assets.*
- 13-B *Sample confirmation letter for other asset accounts.*
- 13-C *Sample work paper -- Other Asset accounts audited.*

What general ledger accounts are part of the "*Other Assets*" account group?

13.01 The "*Other Assets*" account group includes several account classification categories:

- #720 series -- *Other Receivables.*
- #760 series -- *Prepaid Expenses.*
- #780 series -- *Accrued Income.*
- #790 series -- *Other Assets, Assets Acquired in Liquidation of Loans, and Other Real Estate Owned (OREOs).*

How do we review the internal controls over "*Other Assets*"?

13.02 You must review internal controls surrounding "*Other Assets*" and perform tests of controls.

Other Receivable and *Other Asset* accounts may include: ACH,

NOTE: *This Guide is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the Federal Credit Union Act and the National Credit Union Administration Rules and Regulations §715.*

ATM, payroll deductions receivable, non-post draft accounts, and suspense accounts. If your credit union has these accounts, you must complete a thorough review to determine that the balances of these accounts carry no potential losses.

One of the primary accounting concerns with "*Other Assets*" is whether *current and accurate* account reconcilements exist. The other concern is whether or not amounts in the accounts are properly *clearing*. With the wide variety, and in some cases, high dollar balance in these accounts, sound accounting practices are necessary for fairly stated financial statements.

You may use the *Other Asset* internal control checklist in this *Guide*.

What are the audit objectives for "Other Assets"?

13.03 You should determine if:

720s -- *Other Receivables*.

- Internal controls are adequate.
- Adequate accounting records exist.
- The assets are properly classified on the statement of financial condition.

760s -- *Prepaid Expenses*.

- Internal controls are adequate.
 - Adequate accounting records exist.
 - The write-off period is reasonable.
 - The balance in the account represents costs that will benefit future periods.
-

- Prepaid expenses are properly classified on the statement of financial condition.

780s -- *Accrued Income.*

- Internal controls are adequate.
- Adequate accounting records exist.
- Accrued interest receivable on loans and accrued income receivable from investments are fairly stated.
- Accrued income receivable accounts are properly classified on the statement of financial condition.

(You may refer to Chapter 10 -- *Loans* and Chapter 9 -- *Investments* for more audit information on these accounts.)

790s -- *Other Assets.*

- Internal controls are adequate.
 - Adequate accounting records exist.
 - *Assets Acquired in Liquidation of Loans and Other Real Estate Owned (OREO's)* are carried on the books at the lower of cost or current fair value.
 - The credit union is listed as the owner on the title of assets acquired in liquidation.
 - Sales of *Assets Acquired in Liquidation of Loans and OREO's* are properly recorded.
 - "*Other Assets*" are properly classified on the statement of financial condition.
-

What are the audit procedures for "Other Assets"?

13.04 You should:

720s -- *Accounts Receivable*

- Review the "*Other Assets*" internal control checklist.
- Review the account reconciliation for Accounts Receivable as of the audit date.
- Foot the reconciliation.
- Trace significant amounts listed on the reconciliation to the general ledger history report.
- Trace significant amounts listed on the account reconciliation to supporting documentation (invoices or other source documents).
- Review the general ledger account history for the month subsequent to the audit date to determine if significant amounts are clearing properly.

760s -- *Prepaid Expenses.*

- Review the "*Other Assets*" internal control checklist.
 - Trace the balance of the subsidiary records to the general ledger as of the audit date.
 - Review a sample of original invoices for significant dollar amount prepaid expenses recorded in the audit period.
 - Review the write-off period in relation to the cost benefit period of the prepaid expense.
 - Test a sample of monthly write-off calculations.
 - Test a sample of prepaid expense write-offs to the applicable operating expense account.
-

780s -- *Accrued Income.*

- Review the internal control checklists in the *Loan* (Chapter 10) and *Investment* (Chapter 9) general ledger chapters.
- Trace the balance of accrued interest receivable on loans to supporting documentation.
- Test the calculation of accrued interest receivable on a sample of loan accounts.
- Review the schedule for accrued income receivable from investments and test a sample of individual accrual calculations for reasonableness. Include testing of large balance accruals.

790s -- *Other Assets.*

- Review the "*Other Assets*" internal control checklist.
 - Review the account reconciliation for other assets and trace amounts to supporting documentation.
 - Confirm significant amounts for other asset accounts, if applicable (for example, credit card company clearing deposit accounts, CUSO deposits). Refer to the Appendix at the end of this chapter for a sample confirmation letter. You may use this letter to confirm account balances for applicable other asset accounts.
 - Obtain the account reconciliations for *Assets Acquired in Liquidation of Loans* and *OREO's* (if these assets are applicable to your credit union).
 - ⇒ Review the most recent appraisal.
 - ⇒ Ensure that the asset is recorded at the lower of cost or fair value, less any costs to sell the asset.
-

- ⇒ Examine evidence of title, paid property taxes, and current insurance.
 - Review documentation for sales of *Assets Acquired in Liquidation* and *OREO's* for proper accounting treatment.
-

Appendix 13-A -- Internal Control Checklist: Other Assets

The following checklist should help you identify significant operating and internal control weaknesses over “*Other Assets*”, if any. You may find additional guidance in the AICPA’s “*Audits of Credit Unions*” and/or “*Credit Union Audit Manual*.”

Test	Procedure	Yes	No
Accounts Receivable:			
1. Is board of director approval required prior to writing off any balance in an account receivable?	Review the policies and practices for this area. Every collection effort should be made to avoid accounting losses.	<input type="checkbox"/>	<input type="checkbox"/>
2. Are adequate subsidiary records/reconcilements completed monthly?	Review the reconcilements for the last three months to determine if the reconcilements are prepared consistently each month.	<input type="checkbox"/>	<input type="checkbox"/>
3. Are accounts receivable reconcilements periodically reviewed by an individual who usually does not prepare the reconcilement?	Inquire with management or the accounting department to determine if this internal control check and balance is in place and functioning adequately.	<input type="checkbox"/>	<input type="checkbox"/>
4. Do account receivable reconcilements balance with the general ledger and clear properly?	Determine during the review of the accounting records whether or not individual items in the accounts receivable general ledger accounts: <ul style="list-style-type: none"> • Clear within 90 days. • Are properly documented to support their existence? • Should be expensed if not collectible? 	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 13-A -- Internal Control Checklist: Other Assets

Test	Procedure	Yes	No
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Prepaid Expense:

1. Are subsidiary records in balance with the general ledger?	Trace subsidiary records to the general ledger for the audit date.	<input type="checkbox"/>	<input type="checkbox"/>
2. Are original invoices maintained for review?	Request and review a sample of original invoices.	<input type="checkbox"/>	<input type="checkbox"/>
3. Are write-off periods reasonable for prepaid expenses?	Determine if the write-off periods are proper in relation to the expected future benefit of the prepaid item.	<input type="checkbox"/>	<input type="checkbox"/>
4. Are prepaid expense subsidiary records periodically reviewed by an individual who usually does not maintain the accounts?	Inquire with management or the accounting department to determine if this internal control check and balance is in place and functioning adequately.	<input type="checkbox"/>	<input type="checkbox"/>

Other Assets, Assets Acquired in Liquidation and OREO:

1. Are adequate subsidiary records and reconcilements completed monthly?	Determine during the review of the accounting records.	<input type="checkbox"/>	<input type="checkbox"/>
2. Do the subsidiary records balance with the general ledger as of the audit date?	Trace the subsidiary records to the general ledger balance as of the audit date.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 13-A -- Internal Control Checklist: Other Assets

Test	Procedure	Yes	No
3. Does management have a written policy to record/carry assets acquired in liquidation and OREOs at the lower of cost or fair value?	Review the policy and verify a sample of files to determine proper accounting for these assets.	<input type="checkbox"/>	<input type="checkbox"/>
4. Does the credit union have legal title to the assets acquired in liquidation and OREOs?	Review the files for a sample of applicable assets.	<input type="checkbox"/>	<input type="checkbox"/>
5. Are accounting records for assets acquired in liquidation and OREOs periodically reviewed by an individual who does not usually maintain these records?	Inquire with management or the accounting department to determine if this internal control check and balance is in place and functioning adequately.	<input type="checkbox"/>	<input type="checkbox"/>

Note: Questions for the general ledger accounts relating to the *accrued income receivable on loans* and the *accrued income receivable on investments* are in the loan (Chapter 10) and investment (Chapter 9) chapters, respectively.

**Appendix 13-B -- SAMPLE CONFIRMATION
LETTER FOR "OTHER ASSET" ACCOUNTS**

_____ Credit Union

Date _____

Re: Account no. _____

Dear Sir or Madam:

The supervisory committee of the _____ Credit Union is conducting an audit of the books and records. Please confirm the balance for the asset/deposit account number listed above, as of _____. A stamped self addressed envelope is enclosed for your reply. Please respond directly to the Supervisory Committee. Thank you in advance.

Sincerely,

Supervisory Committee member,
_____ Credit Union

Authorized signature:

Manager/CEO
_____ Credit Union

Account balance \$ _____

Confirmed by company representative:

Representative's signature

Title

Date

Appendix 13-C -- *Workpaper Instructions: "Other Assets"*

How do you complete the workpaper provided for Other Assets?

- a) List the general account number for the accounts audited in column 1.
 - b) List the general ledger account description or account title in column 2.
 - c) List the general ledger balance as of the audit date in col. 3.
 - d) If an account reconciliation is available/applicable for the account under review, test the reconciliation:
 - Foot the reconciliation and trace the general ledger balance to the general ledger trial balance as of the audit date.
 - Trace significant amounts on the reconciliation to supporting documentation.
 - Trace significant amounts on the reconciliation to the general ledger history. (The reconciliation should include a reference date to help locate the date of the general ledger entry).
 - After completing the reconciliation testing procedures, enter a "Y" for yes in column 4, "tested reconciliation".
 - e) Complete applicable audit procedures stated in the Supervisory Committee Guide, Chapter 13, for the account under review.
 - f) After completing the audit procedures, enter a "Y" for yes in column 5, "completed audit procedures".
 - g) If a finding is noted based on the audit of the account, place a "Y" for yes in column 6 "reportable condition". Reportable conditions include internal control weaknesses which management should address based on the judgment of the supervisory committee member completing this part of the audit.
-

Chapter 14 -- *HOW DO WE AUDIT “OTHER LIABILITIES”?*

- 14.01 What general ledger accounts are included in the “*Other Liabilities*” category?
- 14.02 How do we review the internal controls over “*Other Liabilities*”?
- 14.03 What are “*Contingent Liabilities*”?
- 14.04 What are suspense accounts?
- 14.05 What are the audit *objectives* for “*Other Liabilities*”?
- 14.06 What are the audit *procedures* for “*Other Liabilities*”?

Appendices

- 14-A *Internal control checklist: “Other Liabilities”.*
- 14-B *Sample attorney letter confirmation.*
- 14-C *Sample work paper - Summary of accounts audited.*

What general ledger accounts are included in the “*Other Liabilities*” category?

14.01 The following accounts are included in the “*Other Liabilities*” account category:

- #800 series - *Accounts Payable.*
- #820 series - *Dividends Payable.*
- #830 series - *Interest Refunds Payable.*
- #840 series - *Taxes Payable.*
- #850 series - *Accrued Expenses.*
- #860 series - *Other Liabilities.*
- #870 series - *Unapplied Data Processing Exceptions.*
- #880 series - *Deferred Credits.*

How do we review the internal controls over “*Other Liabilities*”?

14.02 You must review internal controls surrounding “*Other Liabilities*” and perform tests of controls. You must also complete audit testing similar to that discussed and set forth in the chapter including attached workpapers. Further guidance relative to these

NOTE: *This Guide is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the Federal Credit Union Act and the National Credit Union Administration Rules and Regulations §§715.*

overall objectives is provided in Chapter 7, “*What Steps Must We Take to Complete the Audit Ourselves.*”

You may use the internal control checklist in this *Guide*.

You also must consider *Contingent Liabilities* and suspense accounts. These latter two items we will address next before discussing audit objectives and procedures.

**What are
*Contingent
Liabilities*?**

14.03 Contingent liabilities are estimated probable future expenses which must be accrued for in accordance with generally accepted accounting principles. An example of a contingent liability which may be encountered in a credit union audit is a loss contingency due to pending or threatened litigation (lawsuit).

An audit procedure to verify the existence of pending litigation is to mail an attorney letter to all attorneys used by the credit union. Refer to the sample attorney letter in the appendix to this chapter. The attorney should respond directly to the supervisory committee.

**What are
suspense
accounts?**

14.04 Suspense accounts are used to hold unposted transactions in a separate account until the credit union can process the transactions to the member accounts. Suspense accounts may be established for the following:

- Unposted insurance premium withdrawals.
- Unposted share drafts.
- Unposted payroll deposits and transfers.
- Unposted automated clearing house (ACH) transactions.
- Unposted automated teller machine (ATM) transactions.

Suspense accounts are generally thought of as *higher audit risk* general ledger accounts since the volume and dollar amount of transactions may be high. The potential for an accounting problem may exist in these accounts if the account is not properly

maintained. One audit risk with suspense accounts is that unposted items may accumulate and conceal problems, such as negative share accounts or GL out-of-balance conditions.

It is a good auditing practice to perform a thorough review of all suspense accounts. Suspense accounts with a relatively low dollar balance must be reviewed since the posting of large debits and credits in the account may net to an insignificant account balance; however, the individual items that lead to the balance may be significant. Trace entries to (and from) the account, and fully reconcile the remaining balance as of the audit date. Items in this account which are not resolved and are over one month old should be appropriately documented.

If the supervisory committee has any doubts when reviewing suspense account reconciliations or activity, please seek professional outside accounting or auditing expertise.

What are the audit objectives for Other Liabilities?

14.05 You must determine if:

- Internal controls are adequate.
 - Adequate accounting records exist for other liability accounts.
 - Liability accounts represent authorized obligations of the credit union.
 - Liability accounts are established for all estimated future expenses and contingencies as of the audit date.
 - Other liability accounts are properly classified on the balance sheet.
-

**What are the
audit procedures
for *Other
Liabilities*?**

14.06 You must:

#800s - *Accounts Payable*.

- Review the *Other Liabilities* internal control checklist.
- Review the reconciliation for accounts payable as of the audit date.
- Trace a sample of significant amounts recorded on the reconciliation to supporting documentation.
- Review the general ledger account activity subsequent to the audit date to determine timely payment or clearing of the account balance.
- Review a sample of invoices to determine if invoices are properly approved, marked paid, and are paid in the proper time period.
- Determine if all known significant expenses are recognized as of the audit date by reviewing expenses paid subsequent to the audit date.

#820s - *Dividends Payable*.

- Review the *Other Liabilities* internal control checklist.
 - Review the frequency of dividend payments for all share types offered by the credit union.
 - Ensure that the dividends payable accounts for all share types are fairly stated for dividends earned and not yet paid, based on the board approved dividend rate, as of the audit date.
 - Refer to Chapter 16 in this Guide, “How do we audit Member Shares?” for more information.
-

In computerized credit unions:

- Review the input of dividend payment information into the EDP system program for accuracy and compliance with board approved dividend rates.

In manual credit unions:

- Test a sample of dividend calculations for individual member accounts for accuracy.

#830s - Interest Refunds Payable. First, determine if the credit union offers a loan interest refunds payable program. (Most credit unions don't have this type of program). If the credit union has this type of program:

- Review the *Other Liabilities* internal control checklist.
- Reference the board meeting minutes for approval of the loan interest refunds program.
- Review the accrued liability general ledger account and determine if the liability for the estimated loan interest refunds payable is reasonable as of the audit date.
- Review the balance and activity in general ledger account No. 119, Interest Refunds, and determine if the balance and activity appear reasonable.

#840s - Taxes Payable.

- Review the *Other Liabilities* internal control checklist.
 - Review the taxes payable general ledger accounts as of the audit date and trace the account balance to the credit union payroll records and/or the payroll tax returns.
 - Review a sample of payroll tax payments (check disbursements) to ensure that payroll taxes are paid promptly.
-

- Review a sample of payroll tax returns to determine that payroll tax returns are filed as required by state and federal regulations.
-

#850s - *Accrued Expenses.*

- Review the *Other Liabilities* internal control checklist.
- Review the subsidiary records for accrued expenses for reasonableness and agreement with the total in the GL.
- Determine that accrued expense accounts are established for known liabilities and contingencies.
- Review the need for the following accrued expense accounts related to employee benefits:
 - ⇒ Accrued unused vacation and sick pay (if applicable);
 - ⇒ Accrued employee post retirement benefits (if applicable)
 - ⇒ Accrued pension plan liability (if applicable).
- Review a sample of significant payments made from accrued expense accounts.
- Determine if accrual rates are reasonable and consistent with the amount and expected date of the payout of the liability.

#860s - *Other Liabilities.*

- Review the *Other Liabilities* internal control checklist.
 - Review the reconciliation as of the audit date for Other Liabilities.
-

- Trace significant amounts listed on the reconciliation to supporting documentation.
- Review the general ledger activity subsequent to the audit date to determine if Other Liabilities are properly clearing.

#870s - Unapplied Data Processing Exceptions.

- Review the *Other Liabilities* internal control checklist.
- Review the reconciliation as of the audit date for unapplied data processing exceptions.
- Trace significant amounts listed on the reconciliation to supporting documentation. The supporting documentation will relate to the type of general ledger account. (For example, transactions related to these accounts may be from ATM, ACH, or payroll deductions. Unapplied data processing exception accounts relate to member account activity; therefore, it is particularly important for these accounts to be reconciled and cleared timely).

#880s - Deferred Credits.

- Review the *Other Liabilities* internal control checklist.
 - Determine if the credit union has any deferred credit general ledger accounts. Refer to the *Accounting Manual for Federal Credit Unions*, pages 4-120 to 4-126 for additional information.
 - Review the subsidiary records for deferred credit general ledger accounts (accounts related to income received but not yet earned) and determine if the total is in agreement with the total in the GL.
 - Determine that debits to the deferred credit account and credits to the income in the audit period are appropriate, based on testing. (Income recorded as it is earned).
-

Appendix 14-A -- *Internal Control Checklist: Other Liabilities*

The following checklist should assist you in evaluating operating and internal controls over “*Other Liabilities*”. You may find additional guidance in the AICPA’s “*Audits of Credit Unions*” and/or “*Credit Union Audit Manual*.”

Test	Procedure	Yes	No
1. Are adequate subsidiary records maintained for all liability accounts?	Verify that a reconciliation, supporting schedule or work paper is prepared for all liability general ledger accounts.	<input type="checkbox"/>	<input type="checkbox"/>
2. Is adequate documentation maintained for payments/entries on payable and accrued expense accounts?	Verify that original invoices, data processing reports, etc. are retained for review to support entries made in the accounting records.	<input type="checkbox"/>	<input type="checkbox"/>
3. Are all known liabilities as of the audit date recorded on the general ledger?	Review with management. Some of the types of liabilities to be aware of are: accrued unused vacation and sick pay for employees, accrual for employee post retirement benefits, and accrual for legal expenses.	<input type="checkbox"/>	<input type="checkbox"/>
4. Are accounts payable and accrued expenses reconciled by an individual not directly involved in the payment of expenses?	Review with management.	<input type="checkbox"/>	<input type="checkbox"/>
5. Are all liability accounts reconciled in writing at least monthly?	Review with management.	<input type="checkbox"/>	<input type="checkbox"/>
6. Do individual items in suspense general ledger accounts clear within 30 days?	Review with management. A “no” answer indicates a cause of concern since accounting problems may exist if suspense accounts do not clear timely.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 14-A -- Internal Control Checklist: Other Liabilities

Test	Procedure	Yes	No
7. Are payroll tax returns completed and filed on time?	Review the most recent payroll tax returns.	<input type="checkbox"/>	<input type="checkbox"/>
8. Are all invoices properly approved before payment?	Review a sample of invoices and original checks or check copies to determine if approval and check disbursement activities are separate (if possible) -- segregation of duties.	<input type="checkbox"/>	<input type="checkbox"/>
9. Are bank accounts reconciled by someone independent of the check signer?	Verify the independence of reconciliation and check signature functions. Check signers should not be the primary person to reconcile the bank account.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 14-B -- SAMPLE ATTORNEY LETTER CONFIRMATION

_____ Credit Union

Date , 19__

The supervisory committee of the _____ Credit Union is completing the annual audit as of _____, _____ of the financial statements. Please provide the information requested below directly to the supervisory committee.

Pending or threatened litigation, claims and assessments:

Please provide a list of all pending or threatened litigation, claims or assessments your firm is handling on our behalf, including the following: (1) the nature of the litigation (including the amount of monetary or other damages sought); (2) current status of the case to date, (3) how management is responding or intends to respond to the litigation, and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if possible, of the amount or range of potential loss.

Sincerely,

Authorized signature,
Manager, _____ Credit Union

Appendix 14-C -- *Workpaper Instructions -- "Other Liabilities"*

**How do you
complete the
workpaper
provided for
Other Liabilities?**

- a) List the general ledger account number for the accounts audited in column 1.
 - b) List the general ledger account description or account title in column 2.
 - c) List the general ledger balance as of the audit date in col. 3.
 - d) If an account reconciliation is available/applicable for the account under review, test the reconciliation.
 - Trace the general ledger balance on the reconciliation to the general ledger trial balance as of the audit date.
 - Foot the reconciliation.
 - Trace significant amounts on the reconciliation to supporting documentation.
 - Trace significant amounts on the reconciliation to the general ledger history; the reconciliation should include a reference date to help locate the date of the general ledger entry.
 - After completing the reconciliation testing procedures, enter a "Y" for yes in column 4, "tested reconciliation".
 - e) Complete applicable audit procedures as outlined in this chapter for the account under review.
 - f) After completing the audit procedures, enter a "Y" for yes in column 5, "completed audit procedures".
 - g) If a finding is noted based on the audit of the account, place a "Y" for yes in column 6 "reportable condition". Reportable conditions are findings which should be included in the final audit report, based on the judgment of the supervisory committee member completing this part of the audit.
-

CHAPTER 15 -- HOW DO WE AUDIT “BORROWED FUNDS”?

- 15.01 To help us get started, could you give us some background on “Borrowed Funds”?
- 15.02 What are our audit objectives?
- 15.03 What are our audit procedures?
- 15.04 How do we evaluate and test internal controls?
- 15.05 How do we verify interest on “Borrowed Funds”?

Appendices

- 15-A *Internal Control Checklist: Borrowed Funds.*
- 15-B *Borrowed Funds Confirmation Sample.*

To help us get started, could you give us some background on “Borrowed Funds”?

15.01 Need for Borrowed Funds. Like other businesses, credit unions may need to borrow periodically to meet their short-term operational needs. Credit unions may also borrow funds to finance fixed assets. This is not common due to the expense involved.

In most cases, the credit union should not rely heavily on borrowing. Borrowed Funds are an expensive source of liquidity. If management uses them frequently, they should be able to adequately explain the practice.

There are reasons for borrowing funds, other than simple liquidity or financing assets (for example, investment account relationships). In these cases, verifying the Borrowed Funds becomes more complex. A detailed discussion of these relationships is beyond the scope of this guide. You should refer to the AICPA’s industry guide, *Audits of Credit Unions*, or an outside accountant, for assistance in these cases.

NOTE: *This Guide is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the Federal Credit Union Act and the National Credit Union Administration Rules and Regulations §715.*

Structuring of Notes. Generally, issuers structure notes in three ways:

- a) *Line-of-credit.* Most credit unions establish lines-of-credit to provide a ready source of funds to cover temporary cash needs. This type of loan carries a specific limit set by your board. It typically allows management to access the funds in the amount needed, whenever needed, up to the established limit. A line-of-credit is usually associated with a processing account.
- b) *Installment Note.* A note could require regular payments, much as a consumer loan.
- c) *Balloon Note.* A note could also require a lump sum payment, at a specified future date (maturity). Management should have a definite source of liquidity for the payment and should not continually need to renew the balloon note.

Source of Borrowed Funds. Typically, a credit union will hold a line-of-credit with a corporate credit union. Other sources include banks and thrifts.

What are our audit objectives?

15.02 Your audit objectives are:

- a) Review internal controls.
 - b) Verify that Borrowed Funds are properly authorized and are obligations of the credit union.
 - c) Verify proper recording and reporting of Borrowed Funds and interest on Borrowed Funds.
 - d) Determine whether or not all off-balance-sheet obligations (e.g., operating leases or guarantees) have been identified and considered.
-

**What are our
audit
procedures?**

15.03 Your audit procedures are:

- a) Evaluate and test internal controls to identify weaknesses.
- b) Review board authorization for outstanding lines-of-credit, or other notes payable (management should be able to provide a copy of the board minutes that reflect authorization, if not already in the loan file).
- c) Review supporting documentation (for example, notes, borrowing agreements, etc.). Verify:
 - Maturity.
 - Interest rate.
 - Underlying collateral.
 - Existence and compliance with any other requirements listed in the supporting documentation.
- c) Review account activity, to determine if the credit union is relying on Borrowed Funds to support operations. If so, management should be able to explain adequately why this is necessary.
- d) Confirm the Borrowed Funds with the issuing institution. We have included a sample form in the appendix to this chapter.
- e) Verify the accuracy of the interest on borrowed money.

**How do we
evaluate and test
internal controls?**

15.04 Complete the internal control checklist located in the appendix to this chapter. You will obtain answers from discussions with staff, and through reviewing appropriate documentation.

**How do we verify
interest on
Borrowed
Funds?**

15.05 The institution holding the note will generally list at least year-to-date interest paid on the credit union's statement. If not listed on the statement, estimate the amount owed. Multiply an approximate average amount outstanding, by the interest rate (or an average if the note has a variable rate) to arrive at an annual estimated interest amount. Then convert this figure into the number of months in the current period. Also be sure to verify last year's interest, if covered by your audit period.

Appendix 15-A -- *Internal Controls Checklist: Borrowed Funds*

The following checklist will assist you in evaluating the credit unions operating and internal controls. You may find additional guidance in the AICPA's "Audits of Credit Unions" and/or "Credit Union Audit Manual."

Internal Controls:

Test	Procedure	Yes	No
1. Are borrowing transactions reviewed and approved by the board of directors?	Determine if Board minutes reflect proper authorization for all borrowings.	<input type="checkbox"/>	<input type="checkbox"/>
2. Are adjustments to borrowed funds reviewed and approved by management?	Determine whether the procedures for obtaining additional funds, and the approval for obtaining the funds is sound.	<input type="checkbox"/>	<input type="checkbox"/>
3. Is the statement that reflects borrowed funds activity reconciled to the general ledger?	Determine whether staff timely reconciles the borrowed funds subsidiary with the general ledger. They should be monitoring activity in the account.	<input type="checkbox"/>	<input type="checkbox"/>
4. Is interest expense properly accrued and reported?	Verify computation, accounting and reporting of interest expense.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 15-A -- Internal Controls Checklist: Borrowed Funds

Test	Procedure	Yes	No
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Auditing Procedures:

Refer to the Chapter 15 for additional explanation on these procedures.

1. How do I verify the accuracy of the amount of borrowed funds?	Trace the balance in the general ledger account to the corresponding statement from the lender.	<input type="checkbox"/>	<input type="checkbox"/>
2. What should I look for when reviewing the loan documents?	Verify maturity and interest rate. Review the underlying collateral, and existence and compliance with any other requirements listed in the loan documents.	<input type="checkbox"/>	<input type="checkbox"/>
3. Should I review account activity?	Yes. Reviewing activity will help you determine if the credit union is relying on borrowed funds for liquidity.	<input type="checkbox"/>	<input type="checkbox"/>
4. How do I confirm the borrowed funds?	Send a confirmation notice to the institution issuing the note. Follow-up within several weeks if you do not hear back.	<input type="checkbox"/>	<input type="checkbox"/>
5. How do I verify the interest on borrowed money?	In many cases, you can verify interest paid this year with the statement from the institution. Also verify that the balance is reasonable for loan activity and interest rates.	<input type="checkbox"/>	<input type="checkbox"/>

(USE THE CREDIT UNION'S LETTERHEAD)

BORROWED FUNDS CONFIRMATION

(DATE)

(NAME AND ADDRESS OF INSTITUTION)

Dear (NAME OF AGENT):

Our supervisory committee is conducting an audit of our financial statements. In that regard, please confirm the following outstanding balance on our note which our records indicate that you held on (FINANCIAL STATEMENT DATE).

Please compare this information with your records and complete the section below, regardless of whether it agrees with your records. After signing and dating your reply, please mail it directly to the supervisory committee in the enclosed reply envelope. Thank you in advance for your prompt reply.

Sincerely,

(MANAGEMENT'S NAME/POSITION)
(NAME OF CREDIT UNION)

(LIST NOTE PAYABLE INFORMATION HERE, OR ATTACH TO THIS LETTER.
INCLUDE:

- TYPE OF BORROWED FUNDS (NOTE OR LINE-OF-CREDIT),
- AMOUNT OUTSTANDING,
- MATURITY DATE,
- INTEREST RATE, AND
- UNDERLYING COLLATERAL)

The (above OR attached) agrees with our records as of (FINANCIAL STATEMENT DATE), with the following exceptions:

Signed: _____ Date _____
(Name and Title/Position)

Chapter 16 -- *HOW DO WE AUDIT “SHARES”?*

16.01 What is our audit objective?

16.02 What do we look for in reviewing policies and procedures?

16.03 What audit procedures must we perform to test these internal controls?

16.04 How do we audit the record keeping?

16.05 Could you discuss with us the sample workpapers appended to this chapter?

Appendices

16-A *Internal Control Checklist: Shares.*

16-B *Trial Balance of Members Shares Workpaper.*

What is our audit objectives?

16.01 You must review the internal control policies and procedures in place to safeguard member's shares. Internal controls should be adequate to ensure that:

- a) Members' shares and savings accounts accurately reflect all their ownership interests in the credit union.
- b) Accounts are properly valued, classified, described, and disclosed.

Financial statement presentation is subject to both RAP and GAAP considerations. Federal credit unions with assets greater than \$10 million must report shares on their call report as liabilities.¹ All others may report members' shares consistent with either GAAP (liabilities) or RAP (equity).

¹ Awaiting an opinion from the Office of General Counsel concerning the need to classify shares as liabilities. The portion of the Federal Credit Union Act amended by CEBA conflicts with Title II amended by CUMAA. Matter pending.

NOTE: This Guide is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the Federal Credit Union Act and the National Credit Union Administration Rules and Regulations 715.

What do we look for in reviewing policies and procedures?

16.02 You must determine whether internal control policies and procedures are adequate. For example, sound policies and procedures include directions for the following activities:

- a) Management must reconcile subsidiary ledgers for both share accounts and accrued dividends to their related general ledger control accounts at least monthly.
- b) Supervisory or management-level person(s) review and approve transactions on special activities, such as unposted items, overdrafts, returned items, employee account activity, and dormant account activity.
- c) Duties are segregated to the extent possible. For example, staff opening new accounts or handling member’s share/loan transactions shouldn’t also have access to accounting records. Similarly, accounting staff shouldn’t have teller duties, or have access to unissued certificates.
- d) Wire transfer activity is clearly defined and under dual control to the extent possible.
- e) Documents are adequately protected and controlled, such as signature cards, ledger cards, canceled checks, and deposit tickets. Such items should typically be kept in fire-proof cabinets, with access restricted to appropriate personnel. Also, sensitive supplies like unissued certificates of deposit, which are typically prenumbered, should be kept under dual control.
- f) Members’ statements are regularly mailed to depositors, with proper control and follow-up on returned statements.

What audit procedures must we perform to test these internal controls?

16.03 Attached at the end of this chapter is a sample Internal Control Checklist: Shares (chk1st16.doc) which can aid your understanding of the credit union’s system of internal controls. The tests on the sample checklist include reviews of such key practices as:

- Members' signature cards.
 - Mailing address files.
 - Penalties for early withdrawal.
 - Accounting reconciliations.
 - Segregation of duties.
 - Control over employee accounts.
 - Control over dormant accounts.
 - Disclosures of accounts.
-

How do we audit the record keeping?

16.04 The general ledger control account for *Members Shares* (Account No. 901) should equal the sum of all the individual members' accounts itemized on the credit union's "Trial Balance of Members' Shares." Attached at the end of this chapter is a *sample workpaper* (chptr16.xls) for this audit step. You should report any out-of-balance condition to the board of directors, and ensure staff begins taking corrective action.

Some of the other key review areas include:

- Accrued dividends payable.
- Accuracy of dividend rates paid on members' accounts.

Accrued dividends payable. This area is subject to errors and/or fraudulent transactions that can inflate or deflate the credit union's net income condition. The account balance represents dividends owed by the credit union but not yet credited to the members' accounts. The amount in the account should bear a relation to what part of the dividend period is being audited. For example, if dividends are paid quarterly, an audit period ending 2 months into a quarter (such as February 28) would have a balance equal to about 2/3 the amount of dividend expense in the prior quarter, with some up or down adjustment according to whether shares are increasing or declining.

Accuracy of dividends being paid to members. As a rule-of-

thumb, the amount of dividend expenses should bear a direct relationship to the declared dividend rate. For example, if the board of directors declares a 3.0 percent dividend rate, you should divide the amount of dividend expense by the amount of average shares for the quarter, annualize the result, and have an effective rate of between 2.25 and 3.25 percent.

Could you discuss with us the sample workpapers appended to this chapter?

16.05 The two attached workpapers are examples that you can use to develop your own working papers. They are not all-inclusive, and should be modified according to the level of internal controls in your credit union.

See the instructions provided for each.

Appendix 16-A -- *Internal Control Checklist: Shares*
(chklst16.doc)

What does this checklist accomplish?

Completing this workpaper should help you review operating and internal controls over share account activity of the credit union. The Checklist is designed to be your primary guide for the share audit.

How do we complete the Checklist?

You will need to prepare a number of working papers in the process of answering some questions on the Checklist. We provide one sample workpaper in this chapter, which is the *same* one used in Chapter 10 -- LOANS; you can use either one for compiling and testing subsidiary records with their General Ledger control accounts.

After completing the checklist, you should have enough understanding of the credit union's internal control condition to determine if the shares are properly recorded and reported.

Appendix 16-A -- Internal Controls Checklist: Shares

The following checklist will assist you in reviewing operating and internal controls. You may find additional guidance in the AICPA's "Audits of Credit Unions" and/or "Credit Union Audit Manual."

Test	Procedure	Yes	No
1. Are share policies and procedures effective?	Review the written policies to determine if internal controls are well defined and adequate. [16.03]	<input type="checkbox"/>	<input type="checkbox"/>
2. Is the general ledger in balance with the individual shares?	Reconcile the GL balance with the Trial Balance of Individual Shares and Loans. (Note: Any <i>different</i> ADP system totals, such as a certificate program, should be added to the Trial Balance totals.) [16.05]	<input type="checkbox"/>	<input type="checkbox"/>
3. Are dividend payments correct?	Test-check a sample of members' statements. Recalculate the dividend paid to make sure the ADP is computing the correct amounts. [16.07]	<input type="checkbox"/>	<input type="checkbox"/>
4. Are accrued dividends correct?	Review the balance in the accrual account for reasonableness, reconcile the detailed transactions to the general ledger control balance. [16.06]	<input type="checkbox"/>	<input type="checkbox"/>
5. Are signature cards controlled?	Observe or obtain evidence that cards are soundly originated and controlled. Test a sample of new members for proper qualification and approval for membership. Determine if access to cards is limited.	<input type="checkbox"/>	<input type="checkbox"/>
6. Are mailing lists properly controlled?	Observe or obtain evidence that mailing lists are accurate and access is limited.	<input type="checkbox"/>	<input type="checkbox"/>
7. Are mail receipts properly controlled?	Observe or obtain evidence that mail receipts are opened under dual control.	<input type="checkbox"/>	<input type="checkbox"/>
8. Are withdrawal penalties properly posted?	Test for compliance with policies for early-withdrawal-penalty interest recognition if the credit union offers time deposit certificates. Test a sample of early withdrawals to verify that penalties are properly assessed and posted to the credit union records.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 16-A -- Internal Controls Checklist: Shares

Test	Procedure	Yes	No
9. Are accounts properly reconciled?	Review reconcilements to verify they are prepared regularly, cleared in a timely manner, and are reviewed by an appropriate management individual.	<input type="checkbox"/>	<input type="checkbox"/>
10. Is there adequate segregation of duties?	Observe or obtain evidence there is proper segregation of duties. Persons handling member transactions should not have access to accounting records.	<input type="checkbox"/>	<input type="checkbox"/>
11. Are employee accounts properly controlled?	Determine that an appropriate individual regularly reviews activity in employee and officials' accounts.	<input type="checkbox"/>	<input type="checkbox"/>
12. Is dormant account activity properly controlled?	Determine that an appropriate individual regularly reviews activity in the inactive accounts.	<input type="checkbox"/>	<input type="checkbox"/>
13. Did you review loan reports such as: <ul style="list-style-type: none"> • Paid-ahead loan reports; • Large concentration loan reports; • Loans with no activity; • Zero interest loan reports; • Unpaid interest in excess of loan payment reports? 		<input type="checkbox"/>	<input type="checkbox"/>
14. Did your review cover loan extension and refinance procedures?		<input type="checkbox"/>	<input type="checkbox"/>

Appendix 16-A -- Internal Controls Checklist: Shares

Test	Procedure	Yes	No
15. Did you review the non-financial transactions and/or file maintenance reports: Was there adequate documentation in the file to support any of the following conditions noted? <ul style="list-style-type: none"> • Change in due date to a later time; • Interest rate changes; • Payment amount changes; • Address changes? 		<input type="checkbox"/>	<input type="checkbox"/>
16. Is there evidence of any unusual activity or preferential treatment in an official or employees share or share draft accounts?	Review insider statements or account cards for the audit period. Excessive deposits and withdrawals could indicate check kiting or other improper activity. Negative balances in these accounts would be considered interest free loans which constitutes preferential treatment.	<input type="checkbox"/>	<input type="checkbox"/>
17. Are there any accounts on the trial balance or tape with negative balances?	Review the trial balance or tape as of the audit effective date for negative balance share accounts. Determine the status of each account and calculate the total amount. Report the findings to the board.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 16-B -- Trial Balance of Members Shares Workpaper (chptr16.xls)

What is the purpose of this workpaper?

By completing this workpaper, you will determine whether the general ledger control accounts accurately reflect the total of each member's share balances.

How do we get started?

Obtain a copy of the credit union's Trial Balance of Members' Shares and Loans report as of your audit date. The name of this report may be slightly different, depending on your ADP vendor, but is basically an itemized list of all members' account in the credit union. If your credit union has more than one ADP system for accounts, such as a separate processor for certificate accounts, you'll also need a list of those accounts.

How do we complete the workpaper?

This is a two-part workpaper, with typically no need to go past SECTION A *unless* the shares are out-of-balance for the current month. You should complete SECTION B only to find out if an out-of-balance condition is on-going or just occurred.

SECTION A: Insert the totals of all share types from the general ledger in the first set of input boxes. In the following set of boxes, put the totals from the detailed report of shares and loans. The workpaper computes and displays the amount of any differences.

SECTION B: Insert the share data for the previous 2 months in the boxes provided. Differences are displayed, and you can now observe any changes in the out-of-balance amounts. If the differences don't change, you've found old errors. If the differences change, recordkeeping errors are still occurring.

An out-of-balance condition represents a breakdown of accurate and acceptable recordkeeping. In most cases, you can assume the total of the detailed listing of members' accounts is the true figure, because the members' accounts are verified biannually as correct and members generally report errors when their periodic statements are wrong. If the errors responsible for the out-of-balance condition can't be identified and corrected, the general ledger balance is adjusted to match the individual account totals. The adjustment creates either a loss or a gain.

Be aware that even a few dollars' difference can be significant. Sometimes very large errors might be involved which are offsetting each other between the share and loan control accounts.

What if the differences are due to old errors?

Staff should research and correct the errors. After a reasonable time for corrections, such as 60 days, the differences should be written off, with board authorization, and the general ledger brought into balance with the individual account totals.

What if the differences fluctuate?

Discuss with management what is being done to correct the problem. Report management's corrective actions to the board of directors.

The cause of the recordkeeping errors must be identified and corrected. Make, or cause to be made, test checks on a sample of members' accounts in order to identify what types of postings are causing the problem. Suggested minimum test checks are:

- a) Select a block of at least 25 member accounts at random that have had transactions during the first 10 days of the month you are auditing. Obtain printouts for the transactions on each of these 25 accounts.
 - b) Obtain and have available all posting sources for the 10-day
-

period, such as Cash Received Vouchers, payroll deduction listings, Journal Vouchers, etc. Obtain the detailed list of daily transactions for each of the 10 days.

- c) Compare each transaction on a member's account with the source documents. Each transaction should be accounted for and matched to a proper source. Summarize and report what incorrect postings you identified.

What do we report?

You must report the out-of-balance situation to the board of directors. Your report can include the following recommendations:

- a) Staff should be given a reasonable time limit to research errors and make corrections, such as 60 days, after which the board of directors should authorize and direct staff to adjust the general ledger account balances to bring them in line with the individual account totals.
- b) Adjusting entries shouldn't be made until the board of directors is assured that recordkeeping problems are resolved and the problem won't recur. After correcting the causes of the problem, adjusting entries should be deferred until the accounts are kept in balance for at least 3 months in a row.

What if our credit union doesn't use data processing?

Manual recordkeeping of members' share and loan accounts require additional committee controls and computations:

- You should get control of the ledger cards on a surprise basis, if at all possible, at the start of the audit.
 - Prepare an adding machine tape of the shares in order to complete this workpaper.
-

TRIAL BALANCE OF INDIVIDUAL SHARES

Credit Union:	Ex Why Zee FCU	Audit Date:	12/31/96
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A. CURRENT BALANCES

	TOTALSHARES
Sum of individual accounts from the Trial Balance(s):	395,000,000.00
General Ledger balance for total shares:	400,000,000.00
Potential adjustment/(write-off): [analyze below]	(5,000,000.00)

B. ANALYSIS OF DIFFERENCES - Previous 3 Months

	00/00/00	00/00/00	12/31/96
From the Trial Balance(s):	0.00	0.00	395,000,000.00
From the General Ledger:	0.00	0.00	400,000,000.00
Gain(Loss):	0.00	0.00	(5,000,000.00)

Describe actions by staff to correct differences shown in Sections A and B:

Paragraphs of this chapter will change upon the Board's passage of implementing Prompt Corrective Action regulations. Such regulations will replace existing reserve requirements.

Chapter 17 -- HOW DO WE AUDIT EQUITY?

- 17.01 What is equity?**
- 17.02 What are the different types of equity accounts?**
- 17.03 What are our audit objectives?**
- 17.04 What are our audit procedures?**
- 17.05 How do we test the internal control structure?**
- 17.06 How do we determine that transactions are properly authorized?**
- 17.07 How do we determine that entries are properly classified?**
- 17.08 How do we determine that entries are recorded in the appropriate amounts and at the right time?**
- 17.09 What are the regulation requirements for the Regular Reserve Account?**
- 17.10 How do we determine if Regular Reserve Transfer amounts comply with the regulation?**
- 17.11 How do we verify transfers if management's worksheet is not the same as the one in the appendix?**
- 17.12 How do we verify transfers if staff has not developed their own worksheet?**
- 17.13 What if management did not transfer the correct amount?**
- 17.14 How do we verify other entries to the Regular Reserve account?**
- 17.15 What if capital is negative (a debit balance)?**
- 17.16 Are there other references that we can use for additional clarification of equity account requirements?**

Appendices

- 17-A *Internal Control Checklist: Equity.***
- 17-B *Regular Reserve Transfers Worksheet.***

What is equity? **17.01** Equity is net income that has accumulated since the inception of the credit union. Equity is sometimes referred to as capital, or reserves. It is necessary to have equity to protect the credit union from any future operating losses.

NOTE: *This Guide is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the Federal Credit Union Act and the National Credit Union Administration Rules and Regulations §715.*

What are the different types of equity accounts?

17.02 Equity includes all general ledger accounts from #930 through #950. The separate categories are:

- a) “**Regular Reserves**”. This is a “restricted” capital account, meaning that management does not have ready access to these funds. Regulations require the credit union to transfer funds to this account, until it reaches an adequate level. See Part B on page 17-B-2.
- b) “**Special Reserve for Losses**” is a restricted capital account that the credit union will have only if required by the NCUA.
- c) “**Reserve for Loss Contingencies**”. This is an unrestricted capital account, simply used by the board to earmark reserves for specific unrealized losses.
- d) “**Corporate Central Reserve**”. This is an account used only for corporate central credit unions and will not be discussed further in this Guide.
- e) “**Undivided Earnings**”. This is the account that all credit unions use to store most unrestricted equity (unrestricted accumulated income). Entries to close net income flow through this account. You may also note transfers to other equity accounts.
- f) “**Appropriated Earnings**”. This is a restricted equity account that the board may use to earmark funds for planned expenditures or liabilities. You should not see expenses taken directly from this account. Rather, they flow through operating expenses, net income, and the *Undivided Earnings* account, before final deduction from this account.
- g) “**Accumulated Unrealized Gains/Losses on Available for Sale Securities**”. If the credit union has classified securities as available-for-sale, this account will hold the aggregate unrealized gain or loss on these securities. Auditing requirements are not covered in this chapter. *Chapter 9 -- “How Do We Audit “Investments”?”* addresses this equity account. Only references in this chapter to

aggregate equity apply to this account. Add this account to aggregate equity if there is a gain, or subtract from aggregate equity if there is a market loss.

- h) “**Donated Equity**”. For credit unions following a RAP-basis of accounting, this account represents gifts or donations, of material, tangible assets from outside parties. The account should equal the market value of the asset. (If the asset’s value is immaterial, the offsetting entry would be to “Other Non-operating Income”.)
-

What are our audit objectives?

17.03 Your objectives are:

- a) Determine if internal controls are adequate.
 - b) Verify proper authorization and classification of transactions.
 - c) Verify that all transactions are recorded in the proper amounts and accounting period.
 - d) Verify that transfers to the *Regular Reserve* account comply with regulations.
-

What are our audit procedures?

17.04 Your audit procedures are:

- a) Test the internal control structure relating to equity. You can place less emphasis on internal controls with equity accounts because of required substantive testing under all circumstances.
 - b) Obtain a listing of equity account transactions for the audit period. Ensure that the history includes closing entries for the period.
 - c) Verify that beginning balances tie to the closing balances
-

from the prior audit's workpapers. Tie the ending balances to the appropriate general ledger accounts. Tie the general ledger balances to the financial statements.

- d) Review transactions in all equity accounts. Are all transactions properly:
- Authorized? (other than net income closings, and required regular reserve transfers).
 - Classified? (Should entries run through this account?).
 - Recorded? (Including appropriate amounts, and on the correct date).
- e) Determine the transfer required to the *Regular Reserve* account, and verify that staff transferred the appropriate amount.
-

How do we test the internal control structure?

17.05 Complete the internal control checklist at the end of the chapter.

How do we determine that transactions are properly authorized?

17.06 The board should formally approve all transactions, EXCEPT for net income closings and required *Regular Reserve* transfers. Management should be able to provide you with a copy of the board minutes that reflect appropriate approval. Verify that the board approved the transaction *prior to* the transaction date.

How do we determine that entries are properly classified?

17.07 The only entries that should flow through the equity accounts are:

- Entries to transfer funds between equity accounts.
- Entries to close net income accounts (only to *Undivided Earnings*).
- Entries that reflect prior period adjustments. This type of entry should be rare. Occasionally, management will detect an error that occurred during a prior period. If the error affected net income, or the equity account, staff can make the correction directly to the equity account. Adjustments relating to a net income account that has closed should be made to *Undivided Earnings*.

How do we determine that entries are recorded in the appropriate amounts and at the right time?

17.08 You should trace all entries in the equity accounts to their source.

- Trace entries between equity accounts to both accounts, verifying that the amounts and dates are the same. Also ensure that the transfer is in the amount approved by the board, if it requires board approval.
 - Trace closing entries to the corresponding financial statements, verifying amounts and dates.
 - Question management on accounting problems that caused any write-offs or prior period adjustments to ensure that the reasons are adequate. Trace the entire entry to verify your understanding of the adjustment as described by management. Ensure that the entry is in the amount approved by the board.
-

What are the regulation requirements for the *Regular Reserve Account*?

17.09 These regulations are in transition. The Credit Union Membership Access Act (CUMAA) requires the NCUA to put in place implementing regulations to effect Prompt Corrective Action by certain key dates. The law requires credit unions to make set asides from *Undivided Earnings*, until the account grows to a specified level. The transfer equals a percentage of income.

Specifics of the regulation are pending.

How do we determine if Regular Reserve Transfer amounts comply with the regulation?

17.10 Management may have developed a worksheet for their own use in calculating risk assets and the appropriate transfer amount. If so, you need to do the following:

- a) Review their worksheets that cover the audit period. Verify that management included all applicable accounts on their worksheet and that calculations are accurate. You can use the worksheet in the appendix to this chapter as a guide.
 - b) Verify the accuracy of figures that they used for the worksheet for at least one period. To do this, trace the figures listed on the worksheet to the applicable financial statement or trial balance. Be sure to use *pre-closing Regular Reserves* for your calculation (from the *pre-closing* financial statement).
 - c) Trace the transfer amounts to the *Regular Reserve* account to verify that transfers were for the appropriate amount.
 - d) Verify transfers from *Regular Reserves* to *Undivided Earnings* in an amount equal to the *Provision for Loan Loss* amount for the period.
-

How do we verify transfers if management's worksheet is not the same as the one in the appendix?

17.11 The appendix worksheet calculation specifically complies with the regulatory risk asset definition. Management may use a simplified method of computing risk assets. This is acceptable as long as the results of calculation are the same. The simplified calculation is:

TOTAL LOANS
Less: Share secured loans
Government guaranteed loans, with < 5 yrs maturity
Loans to other credit unions with < 5 yrs maturity
Loans guaranteed by NCUA
Plus: Investments, that are not marked to market, with > 5 yrs maturity
Accrued interest on the above investments
Accrued interest on loans
Other accrued income on risk assets
Receivable accounts
Equals: RISK ASSETS

Management would include in their worksheet only those accounts applicable to your credit union.

How do we verify transfers if staff has not developed their own worksheet?

17.12 If management does not use a worksheet themselves, you need to complete your own to verify all transfer amounts. The calculation should be completed for all closings in the audit period.

The appendix to this chapter includes a sample *Regular Reserve* transfer calculation worksheet. You can use this worksheet or develop your own. You could also request that management completes the worksheet and verify using the steps listed above.

Once you determine the transfer amount, you will verify actual transfers by reviewing the *Regular Reserve* account history. The final step is verifying that *Provision for Loan Loss* amount (for the period) was deducted from *Regular Reserves*, and transferred to *Undivided Earnings*.

What if management did not transfer the correct amount?

17.13 If transfers made to the *Regular Reserve* account are not sufficient, require management to make an additional transfer. The additional transfer should equal the total required transfer amounts, less the transfers made.

If management chooses to transfer additional amounts, or does not want to reverse the period's *Provision for Loan Loss* expense, they must obtain board approval. You should verify that the board approved the voluntary transfers.

How do we verify other entries to the *Regular Reserve* account?

17.14 The only debit entries should be the reversal of the *Provision for Loan Losses*, or correcting entries. Other entries transferring funds out of the *Regular Reserve* account are allowed with NCUA approval. Contact your examiner or SSA if you note any unauthorized deductions.

As noted above, if management chooses to transfer additional amounts to the *Regular Reserves*, they must obtain board approval.

What if capital is negative (a debit balance)?

17.15 If aggregate capital is negative, the credit union is insolvent. You need to contact your examiner or SSA..

Also, note that management is able to pay dividends **ONLY** from the unrestricted equity accounts.

Are there other references that we can use for additional clarification of equity account requirements?

17.16 *Accounting literature* describes equity accounts and the NCUA Rules and Regulations set forth *Regular Reserve* requirements. You could also contact your league, or use the AICPA's industry Guide for the Audit of Credit Unions for additional information.

Appendix 17-A -- *Internal Controls Checklist: Equity*

The following checklist applies to credit unions with a moderate level of control risk with respect to equity. If you identify significant internal control or operational weaknesses, you should consider expanding your audit procedures and testing accordingly. You may find additional guidance in the AICPA's "Audits of Credit Unions" and/or "Credit Union Audit Manual."

Internal Controls:

Test	Procedure	Yes	No
1. Has the board approved all necessary transfers?	Review board minutes for approval. Voluntary Regular Reserve transfers, prior period adjustments, and any other miscellaneous entries should have board approval.	<input type="checkbox"/>	<input type="checkbox"/>
2. Does management review and reconcile accounts?	Ensure that management reviews entries for propriety and accuracy on a regular basis.	<input type="checkbox"/>	<input type="checkbox"/>

Accounting Procedures:

1. Do general ledger balances tie to the financial statements?	Verify amounts.	<input type="checkbox"/>	<input type="checkbox"/>
2. Do the equity histories' ending balances tie to the general ledger account?	Trace the ending balances listed on the equity history account to the general ledger account for ALL equity accounts.	<input type="checkbox"/>	<input type="checkbox"/>
3. Do beginning balances tie to workpapers from the prior audit?	Verify that the beginning history balances equal your ending account figure from the prior audit.	<input type="checkbox"/>	<input type="checkbox"/>
4. Did the board properly approve required transactions?	Trace the history of all equity accounts, and verify that management obtained board approval on applicable entries.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 17-A -- Internal Controls Checklist: Equity

Test	Procedure	Yes	No
5. Are all entries appropriately classified?	Trace the history of all equity accounts. Verify that management did not include entries that should have been recorded in another account.	<input type="checkbox"/>	<input type="checkbox"/>
6. Do net income figures tie to the financial statements?	Trace net income entries to the financial statements for the applicable period.	<input type="checkbox"/>	<input type="checkbox"/>
7. Is there adequate support for prior period adjustments?	Ensure that management is able to adequately explain and support any prior period adjustments.	<input type="checkbox"/>	<input type="checkbox"/>
8. Are entries between equity accounts for the same amounts, and dates?	Verify any inter-equity account transfers.	<input type="checkbox"/>	<input type="checkbox"/>
9. Are transfers to the Regular Reserve account accurate?	Compute the amount of transfer required. Verify the amount actually transferred for all closing periods.	<input type="checkbox"/>	<input type="checkbox"/>
10. Were Provision for Loan Loss expenses accurately transferred?	Ensure that PLL expenses are transferred from Regular Reserves to Undivided Earnings for each closing period.	<input type="checkbox"/>	<input type="checkbox"/>
11. Are deductions from the Regular Reserve account appropriate?	The only debit entries should be as noted in #10 or an adequately supported correcting entry. Contact the examiner if you find otherwise.	<input type="checkbox"/>	<input type="checkbox"/>
12. Is aggregate capital a negative balance?	If total capital is a debit figure, you should contact your examiner.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 17-B --Regular Reserve Transfer Calculation Worksheet Instructions

Note that the letters below (A, B, C, etc.) refer to figures listed on the attached worksheet.

We have included a sample completed worksheet that you can use as a reference when completing the blank form.

COMPLETE THE FOLLOWING NINE STEPS:

PART A - CALCULATING THE RISK ASSET RATIO

1. Complete all input areas on Part A -- "Calculating the Risk Asset Ratio", page 1.
2. Determine the reserve level required by regulation for your credit union.

a) IF your credit union has less than \$500,000 in total assets, OR has been in operation for less than 4 years:

Transfer 10% of gross income, until C equals 7.5%.

Transfer 5% of gross income, until C equals 10%.

Transfers are not required when C is over 10%.

b) IF your credit union has over \$500,000 in total assets, AND has been in operation over four years:

Transfer 10% of gross income, until C equals 4%.

Transfer 5% of gross income, until C equals 6%.

Transfers are not required when C is over 6%.

3. If the ratio (C) is:

- Over 10% for credit unions qualifying under 2(a) above, OR
- Over 6% for credit unions qualifying under 2(b) above, then

Management should not have made a transfer to the Regular Reserve account. You should verify this by reviewing the Regular Reserve account history. Enter the actual amount of the transfer (if there is any) in H.

SKIP TO PART C - "VERIFYING THE OTHER TRANSFERS" OF THESE INSTRUCTIONS.

PART B - CALCULATING THE TRANSFER AMOUNT

1. *If the ratio (C) is less than 7.5% (for 2(a) credit unions), or 4% (for 2(b) credit unions), you need to compute the required transfer at 10% times gross income, for all applicable periods. Complete the gross income section under Part B - "Calculating the Transfer Amount", section (D). At the same time, complete the Provision for Loan Loss amounts (under Part C - "Calculating the Other Transfers"), sections J and K, for the period. Multiply D by 10%, and list under "10% TRANSFER AMOUNT" (F).*

In our example, for the 9/30/95 period, the risk asset ratio (C) was 3.44%. The transfer is computed by multiplying gross income by 10%, or \$303,947 X 10%. The transfer amount is \$30,394. (F) reflects this amount.

2. *If the ratio (C) is between 7.5% and 10% (for 2(a) credit unions), or between 4% and 6% (for 2(b) credit unions), then the required transfer is 5% of gross income. Complete the gross income section under Part B - "Calculating the Transfer Amount", section (D). At the same time, complete the Provision for Loan Loss amounts (under Part C - "Calculating the Other Transfers"), sections J and K, for the period. Multiply gross income by 5%, and list under "5% TRANSFER AMOUNT" (E).*
3. *If the ratio (C) is close to a different transfer rate, you should determine if a "STEP TRANSFER" is required (for example, a 3.9% ratio in a 2(b) credit union). In a step transfer, part of the transfer is made at the higher rate, and the remaining gross income is transferred at the lower rate.*

Complete the gross income section under Part B - "Calculating the Transfer Amount", section (D). At the same time, complete the Provision for Loan Loss amounts (under Part C - "Calculating the Other Transfers"), sections J and K, for the period. Follow the steps outlined in our example below.

Example. Reference the sample worksheet form. The 9/30/95 period ratio (C) is 3.44%, a low enough ratio to avoid a step transfer. However, for the 12/31/95 period, the ratio was 3.89% (close to the 4% ratio, which would trigger a lower transfer rate). To compute the actual amount required:

- Determine the level of statutory reserves needed to reach the 4% risk asset level. In our example this would be risk assets (B) times 4%, or \$347,256
- Subtract current statutory reserves (A) of \$337,658, to arrive at the 10% transfer required, of \$9,598.
- Next, determine the amount of gross income remaining for the 5% transfer. Take gross income, and subtract the amount of gross income you used for the 10% transfer. \$315,817 less \$95,980, or \$219,837.

- Compute the 5% transfer amount by multiplying the remaining gross income by 5%. \$219,837 times 5%, or \$10,992.

OR:

Your Figures

347,256	B times 4%
- 337,658	A
9,598	10% transfer amount (list under F)
315,817	D
- 95,980	10% transfer amount times 10
219,837	Gross income remaining for 5% trfr
X 5%	5% transfer rate
10,992	5% transfer amount (list under E)

4. Now that you have computed the required transfer amount (G), trace this amount to the *Regular Reserve* account.

Fill in the actual amount of the transfer on (H), and compute any difference (I) between your figure and management's. If your computation amount and management's actual transfer amount do not agree, discuss the difference with management. If you determine that management's figure is incorrect, refer to the chapter discussion for considerations.

PART C - VERIFYING THE OTHER CLOSING ENTRIES

1. If you haven't already done so, complete the Provision for Loan Loss section. Use the financial statement for the applicable period. These sections are labeled (J) and (K) on the worksheet.
2. Trace these amounts to the Regular Reserve account. You should notice entries *deducting* these amounts from Regular Reserves (and flowing into Undivided Earnings). Reference the chapter discussion if the amounts do not agree, or these entries are not made.

Chapter 18 -- HOW DO WE AUDIT INCOME?

- 18.01 What is our audit objective?
- 18.02 What accounting issues will we need to address?
- 18.03 What audit procedure do we use to determine if income is properly recorded ?
- 18.04 What do we look for in reviewing policies and procedures?
- 18.05 Could you discuss with us the *Gross Test Workpaper* appended to this chapter?

Appendix

18-A *Gross Test of Interest on Loans Workpaper*

What is our audit objective?

18.01 Your objective is to determine if income is properly recorded and reported.

Your primary goal in this chapter is to test the activity relating to loans, the credit union's primary income producing asset. You will test the income from investments, which represent almost all of the other significant income to the credit union, as part of your Chapter 9 auditing procedures.

What accounting issues will we need to address?

18.02 Income accounts are maintained according to their function, such as loans, investments, and fees and charges. Income is accumulated in these accounts until they are closed into *Undivided Earnings* at the end of each accounting period.

Loan income is usually accrued when earned even if not yet received. As a rule of thumb, the account(s) for accrued income from current loans should have a balance of no more than approximately one-half the earnings for a single month, plus whatever is earned but not yet collected on delinquent loans.

NOTE: *This Guide is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the Federal Credit Union Act and the National Credit Union Administration Rules and Regulations §715.*

Additionally, accrual of income from the delinquent loans is limited by NCUA policy to no more than 3 months of earnings.

What audit procedure do we use to determine if income is recorded properly?

18.03 Perform an analytical test of the income earned in relation to the income actually recorded. Attached as Appendix 18-A is a sample Gross Test of Interest on Loans workpaper. Significant differences you may identify between the income earned and the amount actually collected and/or recorded may indicate fraud and should be reported immediately to the board of directors. A difference greater than +/- 5 percent is typically cause for further and more detailed auditing, such as reviewing income accounts for the possibility of debit entries being used to offset credits to an insider's share account.

Another tool you can use to review accrued interest is a computer generated Accrued Loan Interest Report, which lists accrued interest by each loan. Any loan with a high accrued interest amount should be a delinquent loan or one with a high principle balance. If not, the high figure could be an indication of fraud. If you find unexplained high accruals, check for payment due dates that are advanced to hide delinquency and divert the credit union's income to an insider's account.

You should also be aware of the need for sound, written internal control policies and procedures in relation to the receipt and recording of income.

What do we look for in reviewing policies and procedures?

18.04 You must determine whether internal control policies and procedures are adequate. For example, sound policies and procedures should include directions that:

- a) Subsidiary reports or ledgers for both income received and accrued are reconciled monthly by management to their related general ledger control accounts.
-

- b) Duties are segregated to the extent possible. For example, staff handling member's loan payment transactions shouldn't also have access to accounting records. Similarly, accounting staff shouldn't have teller duties.
-

Could you discuss with us the *Gross Test Workpaper* appended to this chapter?

18.05 The attached workpaper is an example that you can use to develop your own working papers. It is not inclusive, and may be modified and tailored to your credit union.

See the instructions provided for the workpaper.

Appendix 18-A -- *Gross Test of Interest on Loans Workpaper*
(chptr18a.xls)

What is the purpose of this workpaper?

By completing this workpaper, you will verify that the general ledger control account(s) for loan income accurately reflects the total income actually earned by the credit union. The Gross Test is only an estimate, and can't verify exactly the amount collected. It will, however, disclose material overcharges or under collection of interest charged the members, and could disclose fraud.

How do we get started?

Obtain the following:

- The credit union's Statement of Income and Expenses for each month of your audit period, for not less than the previous 12 months.
 - The data processing report that breaks out the loan portfolio by the various interest rates being charged. This report varies between data processors, and may be arranged by loan balances or by collateral types. Many credit unions get this report regularly for management reviews, but you might need to order the report from the processor.
-

How do we complete the workpaper?

We recommend using the software version of this form, which is available to download in Microsoft Excel via Internet through NCUA's home page at www.ncua.gov. Otherwise, you can copy the blank form and calculate by hand those areas for totals and percentages.

The workpaper is designed to detail the amount of loans outstanding at various interest rates in the loan portfolio for each

of the last 12 months. You will fill in the shaded areas to the extent of the information available to you.

Most computer systems can provide a detailed report upon request that can be used as a source for this workpaper. Enter the annual percentage rate (*APR*) detail available from your system in the far left column, and then the loan amounts at each rate for *each of the last 12 months*. With a fair amount of precision, the spreadsheet formulas will calculate the amount of *Earned Interest* income for each month.

You must enter the amount of *Recorded Interest On Loans* for each month in the area provided below the line for *Earned Interest*. Recorded interest can be obtained from the general ledger *Interest on Loans* account. The spreadsheet formulas will then display the percentage difference between the amount of interest earned and the amount actually recorded as collected and accrued. The spreadsheet will also display the word “*YES*” at the bottom of any month where the difference varies by more than 5% in either direction.

What if the differences are greater than 5 percent?

Keep in mind that one or more months may display the “*YES*” warning. When the variance is close to the 5% tolerance, the number of days in a month different from 1/12 of a year can result in display of the warning. More than a few such flags can be cause for concern. The most significant variance is that for the entire 12-month period. If this variance is more than 5 percent in either direction, you should consider expanding your audit of this area.

The *cause* of the variance must be identified. Make, or cause to be made, test checks on a sample of members’ loans in order to identify what is causing the variance. Suggested minimum test checks are:

1. Select a block of at least 10 member loans at random that have had transactions during the first 10 days of the month you are auditing. Obtain printouts for the transactions on each of these 10 accounts.

2. Obtain and have available all posting sources for the 10-day period, such as Cash Received Vouchers, payroll deduction listings, Journal Vouchers, etc. Obtain the detailed list of daily transactions for each of the 10 days.
 3. Compare each transaction on a member's loan with the source documents. Each transactions should be accounted for and matched to a proper source. Summarize and report what incorrect postings you identified.
-

What if our credit union doesn't use data processing?

Manual recordkeeping of members' share and loan accounts require additional committee controls and computations:

- You should get control of the ledger cards on a surprise basis if at all possible at the start of the audit.
- Prepare an adding machine tape of the loans in order to complete this workpaper.
- Most credit unions have more than one interest rate for loans. It's necessary to determine the portion of loans that are made at each rate. This can be done during the review of loans by using a symbol to identify, on your tape of the loans, the different annual percentage rates (APRs) of the loans reviewed. Afterwards, these identified loans can be totaled for each APR, and a ratio calculated for the amount each APR represents in the entire loan portfolio. These ratios can then be used to calculate the amount of loans outstanding at each APR, and the results entered into the attached Gross Test workpaper.

Example:

Assess the ratios identified in the loan review are as follows:

25% of the loans are at 15% APR

75% of the loans are at 10% APR

then

$0.25 \times \text{Loans} = \text{Gross Test @ 15.0\% APR}$

$0.75 \times \text{Loans} = \text{Gross Test @ 10.0\% APR}$

- Using these calculations, enter APRs into the column on the left side of the spreadsheet and the corresponding loan balances for just your audit date into the right side column. Don't enter any loan balances in the individual month columns.
- Enter the amount of Recorded Interest for the prior 12-month period, using the financial statements, in the block provided in the far right column.

The spreadsheet will calculate and display the amount of Earned Interest in the right side column, and show you if the variance exceeds 5%.

Chapter 19 -- HOW DO WE AUDIT EXPENSES?

- 19.01** What general ledger accounts are included in the operating expense area?
- 19.02** What is the general audit strategy for operating expenses?
- 19.03** How do you increase testing of operating expenses?
- 19.04** How do you review internal controls over operating expenses?
- 19.05** What are the general audit objectives for operating expenses?
- 19.06** What are the general audit procedures for operating expenses?
- 19.07** How do you complete an analytical review of operating expenses?
- 19.08** What are the audit objectives for *Employee Compensation and Benefits Expense*?
- 19.09** What are the audit procedures for *Employee Compensation and Benefits Expense*?
- 19.10** What are the audit objectives for *Dividend Expenses*?
- 19.11** What are the audit procedures for *Dividend Expenses*?
- 19.12** What are the audit procedures for *Employee Travel and Conference Expense*?
- 19.13** What are the audit procedures for *Cash Over and Short*?
- 19.14** What are the audit procedures for the corporate credit card account?
- 19.15** What are the audit procedures for other operating expense categories?

Appendices

19-A *Internal Control Checklist: Expenses.*

19-B *Operating Expenses Worksheet.*

What general ledger accounts are included in the operating expense area?

19.01 The 200 - 300 series of accounts in the general ledger identify the expense accounts credit unions use.

Operating expenses include the following accounts:

NOTE: *This Guide is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the Federal Credit Union Act and the National Credit Union Administration Rules and Regulations §§715.*

<u>Acct #</u>	<u>Category</u>
210	Compensation Expense.
220	Employee Benefits Expense.
230	Travel and Conference Expense.
240	Association Dues.
250	Office Occupancy Expense.
260	Office Operations Expense.
270	Educational and Promotional Expense.
280	Loan Servicing Expense.
290	Professional and Outside Services.
300	Provision for Loan Loss.
310	Member Insurance.
320	Federal Operating Fee Expense.
330	Cash Over and Short.
340	Interest on Borrowed Money Expense.
350	Annual Meeting Expenses.
360	Truth in Lending Expenses.
370	Miscellaneous Operating Expenses.
380	Dividend Expense.
385	Interest on Deposits.

What is the general strategy for auditing operating expenses?

19.02 Due to the number of operating expense accounts and the volume of transactions, a good audit strategy is to complete a thorough review of the material expense accounts (those with a higher dollar balance) and to exercise sound judgment for the selection of other expenses for review. You may use analytical review (See 19.07 for further details) to determine the selection of the other expense accounts to review.

In general, the expense accounts with the highest dollar balances which require a detailed testing are:

- *Dividend Expense.*
- Compensation Expense.
- Employee Benefits Expense.

In general, the other expense accounts which should be reviewed

to determine if there is abuse are:

- Travel and Conference Expense.
- Cash Over and Short.
- Miscellaneous Expense.

In addition, if your credit union has a corporate credit card account for management or officials, the credit card activity should be reviewed to determine if there is abuse.

How do you increase testing of operating expenses?

19.03 You increase testing of operating expenses by increasing the sample size of your review scope.

You increase testing of operating expenses when:

- Internal controls are weak.
 - There is a material dollar or percentage increase in an operating expense account(s).
 - There is a large budget variance (difference between actual versus budget amount).
 - A reasonable explanation is not provided by management for an inquiry.
-

How do you review the internal controls over expenses?

19.04 You may use the internal control check list in this chapter.

What are the general audit objectives for operating expenses?

19.05 You:

- Determine that internal controls relating to expenses are adequate.
- Determine that accounting practices recognize expenses on a reasonable and consistent basis.
- Determine that expenses are authorized and are approved credit union business expenses.
- Determine that expenses are properly classified on the income statement.

What are the general audit procedures for operating expenses?

19.06 You:

- Review internal controls relating to operating expenses.
- Complete an analytical review of each operating expense account.
- Test expenses by selecting a sample of expenses recorded in the general ledger in the audit period and trace to source documentation such as the bill of sale or subsidiary ledgers for prepaids and furniture and fixtures.
- Review the board meeting minutes to determine that operating expenses are approved monthly.
- Trace the general ledger expense account balances to the credit union's income statement.

Refer to the appendix to this chapter for a sample work paper to document the expense review. Instructions are included.

How do you complete an analytical review of operating expenses?

19.07 Analytical expense review involves the comparison of expense account balances for at least two audit periods. For example, if the audit date is December 31, you compare the expense account balance as of December 31, 2002, with the prior year balance as of December 31, 2001. A significant dollar or percentage difference triggers a need for further review.

Further review of the expense account involves inquiries with management and verifying a selected sample of expenses.

Supervisory committee members familiar with ratio analysis may use ratio comparisons for the analytical review procedure.

Another analytical review procedure for operating expense is the comparison of actual expenses with budgeted expenses. A budget variance report should be completed by management and submitted to the board of directors for review. You may use the budget variance report to trigger the review of significant budget variances.

What are the audit objectives for *Employee Compensation and Benefits Expense*?

19.08 You:

- Determine that internal controls are adequate for reliance.
 - Determine if adequate records exist for payroll, taxes, payroll expenses and employee benefits.
 - Determine if payroll and benefits programs are properly approved.
 - Determine if compensation and benefit expenses are properly classified on the income statement.
 - Determine if salaries and bonus amounts being paid are what have been approved by the board.
-

What are the audit procedures for *Employee Compensation and Benefits Expense*?

19.09 You:

- Review the internal controls relating to payroll and benefits expense.
- Perform an analytical review of payroll and benefits expense.
- Trace payroll expenses recorded in the general ledger in the audit period to source payroll documentation.
- Trace employee salary in the payroll records to management/board approval.
- Review payroll tax returns to determine if they are filed properly.
- Review payment of tax liabilities for compliance with state and federal tax laws.
- Review new benefit programs (insurance, pensions, etc.) for board approval.
- Trace a sample of benefit expenses recorded in the general ledger in the audit period to invoices or source documents.

What are the audit objectives for *Dividend Expense*?

19.10 You:

- Determine if internal controls are adequate.
 - Determine if dividends are properly approved.
 - Determine if dividend expense is fairly represented.
 - Determine if dividend expenses are properly classified on the income statement.
-

What are the audit procedures for *Dividend Expense*?

19.11 You:

- Determine if *Dividends Payable* and *Accrued Interest Payable* are fairly represented as of the audit date.
- Test a sample of individual accrued dividend and interest calculations.
- Test a sample of individual dividend paid transactions on a member statement or account history.
- Test dividend and interest expense recorded in the general ledger to dividend paid reports for a selected period (for example, the audit year).
- Review the board minutes for board approval of dividend rates in the audit period.
- Compare the yields on share products with dividend rates in effect for the audit period.

What are the audit procedures for *Employee Travel and Conference Expense*?

19.12 You:

- Review the board approved policy for travel and conference expenses.
- Review a sample of travel and conference expenses recorded in the audit period to determine if the expense is:
 - ⇒ Properly documented.
 - ⇒ Within the board approved policy.
 - ⇒ Within the budget and affordable by the credit union.
 - ⇒ Relevant to credit union business.
 - ⇒ Authorized by management or the board of directors.

What are the audit procedures for *Cash Over and Short Expense*?

19.13 You:

- Review the board approved cash over and short policy.
 - Review the teller cash over and short log (maintained to record over and short situations).
 - Review cash over and short expense in total and by individual tellers.
 - Review any significant cash over or short problems in the audit period, and determine if management is effective in minimizing cash over and short expense.
-

What are the audit procedures for the corporate credit card?

19.14 You:

- Review the corporate credit card statements issued in the audit period.
 - Review the receipts maintained with the statements.
 - Review the appropriateness of the charges on the credit card account(s).
 - Verify that an individual other than the cardholder is reviewing and paying the credit card bill.
-

What are the audit procedures for other operating expenses?

19.15 Refer to paragraph 19.06 in this chapter for the general guidelines to use for reviewing other operating expense categories.

Appendix 19-A -- *Internal Controls Checklist: Expenses*

The following checklist will help you review operating and internal controls relative to expenses. You may find additional guidance in the AICPA's "*Audits of Credit Unions*".

Test	Procedure	Yes	No
1. Do the board minutes contain an up to date record of the names of officials and employees who are authorized to sign credit union checks?	Review the board meeting minutes for board approval on all current check signers. Board's goal should be appropriate segregation of duties and setting limits on the number of staff authorized to sign checks.	<input type="checkbox"/>	<input type="checkbox"/>
2. Are banks or other financial institutions immediately notified to remove terminated employees from the authorized check signer list?	Inquire with management. The credit union should have a practice in place to immediately notify the bank if an employee with check signing authority is terminated, resigns, retires, etc. This limits the opportunity for an unauthorized transaction to occur on the account.	<input type="checkbox"/>	<input type="checkbox"/>
3. Are invoices or supporting expense documentation provided to the authorized check signer prior to signing/ completing the check?	Inquire with management. Supporting documentation must be supplied to the authorized check signer before issuing the check.	<input type="checkbox"/>	<input type="checkbox"/>
4. Are checks prenumbered and accounted for?	Review check storage procedures with management. Checks should be numbered and used sequentially. The beginning and ending check numbers should be monitored and recorded daily.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 19-A -- Internal Controls Checklist: Expenses

Test	Procedure	Yes	No
5. Are voided checks properly maintained?	Review voided check procedures with management. Voided checks should be marked as such to prevent an unauthorized use of the check.	<input type="checkbox"/>	<input type="checkbox"/>
6. Are bank reconcilements prepared monthly by persons not directly involved in paying expenses?	Review who completes the bank reconciliation and who the authorized check signers are. These duties should be separate if the staff size of the credit union is adequate for a segregation of duties.	<input type="checkbox"/>	<input type="checkbox"/>
7. Does the board of directors approve operating expenses each month after the review of the income statement?	Review the board minutes to note monthly approval. Determine if the board reviews operating expenses that are materially above budget or that show an unexplained large increase.	<input type="checkbox"/>	<input type="checkbox"/>
8. Are employee salaries approved at least annually by the board of directors?	Review the board minutes to verify that the board approves employee salaries annually. The minutes should contain a list that includes the employee name, position, and approved annual salary or hourly pay rate. Are written procedures in place and followed?	<input type="checkbox"/>	<input type="checkbox"/>
9. Do all employees receive a written annual review or performance appraisal before salary increases are approved?	Recommended for sound personnel management. A performance appraisal should be completed prior to salary adjustments. Are written procedures in place and followed?	<input type="checkbox"/>	<input type="checkbox"/>
10. Are records maintained for employee earnings, vacation and sick pay?	Records must be maintained in a personnel file or similar record keeping system to document current salary, unused vacation, sick, personal days, etc. Are written procedures in place and followed?	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 19-A -- *Internal Controls Checklist: Expenses*

Test	Procedure	Yes	No
11. Are tax returns completed on time and is this verified by someone other than the primary employee who completes the return?	Verify that payroll tax returns are completed on time and that payroll tax liabilities are paid on time. Another employee should verify that these items are completed, to avoid the possibility that fines and penalties could be levied for incomplete returns or late payment of tax liabilities.	<input type="checkbox"/>	<input type="checkbox"/>
12. Are employees and officials with corporate credit cards prohibited by written policy not to use the card for personal reasons?	Corporate credit card controls must be reviewed due to the potential for abuse or inappropriate activity. All employee and official corporate credit card accounts should be monitored monthly.	<input type="checkbox"/>	<input type="checkbox"/>
13. Is senior management required to approve employees to attend out of town seminars?	Recommended to limit the potential for expense abuse. Notation should be documented in the board meeting minutes for any conferences attended for a significant dollar amount.	<input type="checkbox"/>	<input type="checkbox"/>
14. Is board of director approval required for senior management to attend out of town seminars?	Recommended to limit the potential for expense abuse. Notation should be documented in the board meeting minutes for any conferences attended for a significant dollar amount.	<input type="checkbox"/>	<input type="checkbox"/>
15. Is a periodic independent review completed for conference expenses and corporate credit card statements?	A supervisory committee or board of director member should review this activity monthly. If this activity is reviewed monthly by an independent individual, the audit scope may be adjusted accordingly.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 19-A -- Internal Controls Checklist: Expenses

Test	Procedure	Yes	No
16. Are dividend and interest rates approved by the board of directors and included in the minutes?	Review for approval in the board minutes. Approval must be documented for each dividend period.	<input type="checkbox"/>	<input type="checkbox"/>
17. Are dividend paid reports retained for review, either in hard copy form or on microfiche?	Inquire with management. These records should be retained for use during the audit.	<input type="checkbox"/>	<input type="checkbox"/>
18. Are vendor invoices marked paid and filed to prevent duplicate payment?	Review a sample of paid invoices to determine that individual invoices are appropriately documented and filed for future reference.	<input type="checkbox"/>	<input type="checkbox"/>
19. Are all invoices approved by an authorized individual (management) prior to payment?	Review a sample of paid invoices to determine that an authorized individual is documenting approval for the expense.	<input type="checkbox"/>	<input type="checkbox"/>
20. Are overall internal controls over cash in bank accounts adequate?	Refer to the internal control check list for cash in bank, Chapter 8. Weak internal controls over cash in bank affect the check payment of expenses.	<input type="checkbox"/>	<input type="checkbox"/>

Appendix 19-B -- *Operating Expenses Workpaper Instructions*

How do you complete the workpaper provided for operating expenses?

You:

- a) List the general account number for all credit union operating expense accounts in column 1.
 - b) List the general ledger account description or account title in column 2 for all operating expense accounts.
 - c) List the general ledger account balance, as of the audit date, in column 3.
 - d) Complete the analytical review procedure for all operating expense accounts. After completing, place a "Y" for yes in column 4.
 - e) Include the analytical review workpaper used to document the work was performed. The workpaper should document the comparison of the current audit period with the prior audit period. Refer to Chapter 19, analytical review section.
 - f) Complete the applicable audit procedures stated in the *Supervisory Committee Guide for Credit Unions* for the account under review.
 - g) Enter a "Y" for yes in column 5, "completed audit procedures". Include the supporting work papers used for the audit of the expense account.
 - h) Place an "N/A" for not applicable in column 5, if specific auditing procedures were not completed for a particular expense. A short explanation should be provided to document why a particular expense account was not reviewed, such as:
 - Immaterial account balance.
 - Balance consistent with prior year.
 - i) Place a "Y" for yes in column 6 "reportable condition". Reportable conditions are findings which should be included in the final audit report, based on the judgment of the supervisory committee member completing this part of the audit.
-

Chapter 20 -- HOW DO WE AUDIT “RELATED PARTY TRANSACTIONS”?

- 20.01** What are “related party transactions”?
- 20.02** How do you identify the “related party” accounts for the audit?
- 20.03** What are the audit objectives for “related party transactions”?
- 20.04** What are the audit procedures for “related party transactions”?
- 20.05** How do you audit loans to employees and officials?
- 20.06** How do you audit share accounts for employees and officials?
- 20.07** What are some examples of “reportable conditions”?

Appendices

- 20-A** *Internal control checklist: Related Party Transactions.*
- 20-B** *Sample workpaper -- Schedule of employee and official loan and share accounts audited.*

What are “related party transactions”? **20.01** “*Related party transactions*” are business transactions between the credit union and the employees, board of directors, committee members and/or their relatives. Common types of related party transactions are loans and share accounts. Other types of related party transactions may be the use of vendors or suppliers that are related to credit union employees or officials.

How do you identify related party accounts for the audit? **20.02** You start the review of “related party transactions” by obtaining a listing of employee/official names, addresses, social security and account numbers. The manager should have a list with this information. The EDP system terminal may be used (for credit unions with an EDP system) to locate account numbers for related parties.

NOTE: *This Guide is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the Federal Credit Union Act and the National Credit Union Administration Rules and Regulations §715.*

The procedures that may be used are:

- Complete a last name search.
- Complete an address search.
- Complete a social security number search.

You must review “off-line” loan trial balances to be certain that all loan types are reviewed. Off-line loans are loans that do not appear on the credit union’s main EDP system. Examples of off-line loan products are: credit card loans, real estate loans, student loans, vehicle leases, etc.

Other ways to become aware of related party transactions include:

- Review of board meeting minutes.
 - Review a sample of expenses or paid bills during the audit period.
-

What are the audit *objectives* for “related party transactions”?

20.03 You determine if:

- Internal controls are adequate.
 - Favoritism, conflicts of interest or insider abuse are prohibited.
-

What are the audit *procedures* for “related party transactions”?

20.04 You should:

- Review internal controls over related party transactions. Refer to the internal control checklist at the end of this chapter.
 - Inquire with management about related party transactions. Ask the manager if he/she is aware of any material related party transactions.
 - Review the board meeting minutes for information on related
-

party transactions. Read the board meeting minutes to determine if any information on related party transactions is disclosed.

- Complete or obtain a schedule of employee, official and relatives loan/share balances. Refer to the Appendix at the end of this chapter for a sample schedule. In some credit unions, this type of report is already available if the EDP system has the capability to “code” or identify accounts belonging to employees and officials. If the accounts are “coded” a report of share and loan balances may be easily completed. Verify that the coding system is properly used.
- Review loans to related parties. Refer to Chapter 8 in this Guide for the detailed information on how to review a loan. Review share account activity for related parties. Refer to section 20.06 in this Chapter for information on how to review share account activity.
- Determine if employees, management, directors or officials receive preferential treatment for loan rates, loan terms, service charges, dividend and interest rates on shares/certificate accounts. Compare the loan rates with the board approved loan interest rate schedule. Compare the loan term with the board approved loan policy. Compare the share dividend rate with the board approved dividend rate. Compare the services and fees charged with the board approved fee income schedule.
- Review a sample of expenses and paid bills to determine if any related party transactions exist with vendors or suppliers. Keep an awareness of possible related party transactions when reviewing expenses.

How do you audit loans to official and employees?

20.05 Refer to Chapter 10, “*How Do We Audit Loans?*”, in this *Guide* for the audit procedures.

How do you audit share accounts for employees and officials?

20.06 You review the account history for a sample time period. Usually one calendar quarter of account activity is a satisfactory sample time period. You may review statements, account history printouts, or the history on the computer terminal screen.

Pay particular attention to the following:

- Large dollar amount transactions.
- Frequent check deposits and check withdrawals (may be an indication of check kiting).
- Negative balance in share or share draft accounts.
- Unidentified journal entries between the General Ledger and a related party account.
- Failure to impose fees for certain transactions (such as NSF drafts), as stated in the credit union policy.

Expand your time frame of review if there are any indications of inappropriate activity.

What are some examples of “reportable conditions” for “related party transactions”?

20.07 The following items serve as examples of “reportable conditions” that should be included in the audit report to the board of directors. These conditions may require written notification to the surety bond company:

- Delinquent loans.
 - Preferential loan interest rate, term or collateral.
 - Material violation of loan policy.
 - Negative share or draft account.
 - Preferential share dividend or interest rate.
 - Failure to impose a fee in relation to credit union policy (NSF fee, ATM fee, etc.).
 - Unauthorized changes to insider’s share and loan accounts, detected through a review of file maintenance reports.
-

**Appendix 20-A -- Internal Controls Checklist: Related
Party Transactions**

The following checklist will assist you in reviewing operation and internal controls over related party transactions. You may find additional guidance in the AICPA's "*Audits of Credit Unions*" and/or "*Credit Union Audit Manual*."

Test	Procedure	Yes	No
1. Are loans to employees approved by independent individuals, such as the credit committee?	Verify that good Internal controls are in place to ensure the credit committee approves loans to employees. It is preferable for loans to employees to be approved by individuals independent of co-workers.	<input type="checkbox"/>	<input type="checkbox"/>
2. Are aggregate loans over \$20,000 to officials approved by the board of directors?	Review the board minutes to determine that board approval is documented for aggregate loans over \$20,000 to all officials. This approval is required by the law for Federal credit unions.	<input type="checkbox"/>	<input type="checkbox"/>
3. Is a current list of account numbers for employees and officials maintained?	Verify that the manager maintains a current account list for all employees, officials and related individuals. If a current list is not maintained, this is an indication that accounts are not properly monitored.	<input type="checkbox"/>	<input type="checkbox"/>
4. Does the manager periodically review share and loan account activity for the employees' accounts?	Verify. If the accounts are not periodically reviewed, the supervisory committee must complete a thorough review of this area at the time of the audit.	<input type="checkbox"/>	<input type="checkbox"/>
5. Does the supervisory committee periodically review share and loan activity for the manager's accounts?	Verify. If the accounts are not periodically reviewed, the supervisory committee must complete a thorough review of this area at the time of the audit.	<input type="checkbox"/>	<input type="checkbox"/>
6. Are negative account reports and NSF draft reports properly monitored?	Determine if management reviews these reports for possible employee or official account abuse. These reports should be filed and readily available for review.	<input type="checkbox"/>	<input type="checkbox"/>

**Appendix 20-A -- Internal Controls Checklist: Related
Party Transactions**

Test	Procedure	Yes	No
7. Are computer file maintenance reports independently reviewed for data changes?	Recommended for sound internal controls. Does an employee who does not have the ability to complete data changes to the share and loan accounts review the report of data changes for each business day? Does he/she also review for any unusual data changes through inquiry and investigation?	<input type="checkbox"/>	<input type="checkbox"/>

Chapter 20 --RELATED PARTY TRANSACTIONS

Workpaper instructions for Completing Appendix 20-B

How do you complete the work paper provided for related party transactions?

You should determine if an alternative work paper is available to document this review, e.g., can your credit union produce a share and loan trial balance run for only employee and official accounts?. If such a report is available at your credit union, check its accuracy by comparing a sample of accounts to the standard share and loan trial balance report. If the account balances match and the report is accurate, the trial balance for employee and official accounts can be used to document your related party transaction review.

If this report is not available at your credit union, than the sample workpaper provided will provide satisfactory evidence that the accounts were audited.

You complete the following data:

1. List the employee's or official's name in column 1.
2. List the employee's or official's position in column 2.
3. List the employee' or official's account number in column 3.
4. List the share account balance in column 4.

In the Loan data fields, you:

- List the original loan amount.
- List the current loan balance as of the audit date.
- List the original loan date.
- List the loan interest rate.
- List the collateral, if any.
- List the loan term in number of months.
- List the current delinquency status (number of months delinquent, if any, as of the audit date).

In the review field, you:

- List a "Y" for yes after reviewing the loan file, in the Loan Reviewed column.
 - List a "Y" for yes after reviewing the share account activity, in the Share reviewed column.
-

If a loan exception is noted in the loan review, list a “Y” for yes and ensure that the exception is included in the loan exceptions document for your audit report (refer to Chapter 10, “*How do we audit loans?*”).

If no loan exception is noted, list a “N” for no in the Exception column.

Chapter 21 -- HOW DO YOU REVIEW AN EDP SYSTEM?

- 21.01 Why is it important to review the EDP system?**
- 21.02 What should be our objectives in evaluating the EDP system?**
- 21.03 What is a system survey and what do we need to know about the process of conducting a system survey?**
- 21.04 What are management controls and how do you assess them?**
- 21.05 Could you discuss organizational management controls?**
- 21.06 What management controls should we look for relevant to planning for growth?**
- 21.07 What management controls should we look for governing contracted services?**
- 21.08 What management controls should we look for governing disaster recovery?**
- 21.09 Could you give us an overview of general controls?**
- 21.10 What general controls should we look for governing system security?**
- 21.11 What do you need to know about general controls related to backup procedures?**
- 21.12 What do you need to know about general controls related to computer operations?**
- 21.13 What do you need to know about application controls?**
- 21.14 What do you need to know about application controls related to programming standards?**
- 21.15 What do you need to know about application controls related to program changes?**
- 21.16 What do you need to know about data processing application controls?**

Appendix

21-A *EDP System Survey Worksheet*

NOTE: This Guide is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the Federal Credit Union Act and the National Credit Union Administration Rules and Regulations §715.

Why is it important to review the EDP system?

21.01 Most credit unions have computerized their systems.

Due to the role of the computer in credit union operations it is imperative this area be reviewed during the audit process. Therefore consideration should be given to selecting at least one individual with computer knowledge as part of the supervisory committee.

What should be our objectives in evaluating the EDP system?

21.02 Your objectives are to:

- a) Gain a general understanding of how the credit union manages the EDP operation.
- b) Identify the various parts of the computer operations and the staff responsible for those parts in the organization chart.
- c) Ensure proper information is being provided to management to guide decisions in planning for the credit union's growth.
- d) Determine the extent to which the credit union relies on contracted services.
- e) Ensure policies governing contracts are being followed for the EDP area.
- f) Ensure Disaster Recovery plans are established and properly validated.
- g) Ensure proper back-up procedures have been implemented and are being followed.
- h) Determine if the board has developed policies addressing the security of credit union records and confidential member data.

You will need to test:

- a) Media security of electronic data.
-

- b) Physical security of equipment that processes the data.
- c) System reconstruction ability in case of a disaster.

The purpose of these objectives is to protect the investments of members, to protect the security of members data, and to ensure the ongoing operation of the credit union. You should always be aware of these objectives when doing the EDP audit.

In conjunction with these objectives the following procedures are provided to give you the ability to:

- a) Perform a computer system audit of a small credit union (CU).
- b) Contract for an EDP audit of the computer system in large operations.
- c) Review the EDP audit report for reasonableness.

Your report on the outside audit report should identify:

- The control areas reviewed or contracted for review.
- The extent of the review of the control areas.
- Results of review.
- Recommendations, as appropriate.

As with any type of audit, workpapers should reflect the steps performed while doing various tests.

In this chapter, we identify the steps required to perform an audit of a small credit union computer system. Within this section, we will identify the criteria used to determine when the hiring of an outside EDP auditor would be appropriate. Also included will be the steps that you can complete when contracting for an outside EDP audit. Finally, the steps provided can be used as a reference when reviewing an EDP audit report for reasonableness. The starting point is a system survey.

What is a system survey and what do we need to know about the process of conducting a system survey?

21.03 Appendix Tool. Appendix 21-A includes an example of a system survey form. You can complete the System Survey step yourselves or verify the completion of it by another. The survey should help you identify all the systems currently computerized in the credit union and indicate the importance of that system to the credit union. The survey procedure will help you determine areas to be audited. Performing an extensive audit of programming controls may not be applicable when a credit union purchases software.

Use of Outside Auditor. If you are not familiar with a particular system's computer and operating system, consider hiring an outside auditor. The type of hardware and related operating system should also be an indication of the need to hire an outside auditor to perform the review. When contracting for an outside EDP audit, provide the survey information to the outside auditor.

Objective of Survey. A system survey will help you determine the current level of computerization that exists at the credit union. The survey should identify all computerized systems and the required hardware on which the system runs. In addition, it should rate the systems as to relative importance to the overall operation of the credit union. That is,

- Can the credit union operate if a particular system is down a half day, one day, one week, or a month?
- Can the credit union recreate the system if the data is a total loss?
- If not, is the data necessary for the continued operation of the credit union?
- Are any of the services supplied by a third-party?

The objective of the survey is to identify:

- Software currently being used by the credit union.
 - Hardware that the software requires.
-

- Relative importance of the software to credit union operations.
- Ability to recreate should electronic data be destroyed.

The survey is the basis of all EDP reviews. Controls that affect those items rated high in importance would have first priority. Considering the results of the survey, you can determine where to place the EDP audit effort. The following is a list of some of the possible computerized systems:

Shares and Loans
Investments
General Ledger
Payroll
Check Register
Accounts Payable
Fixed Assets
ATM machines
Credit Cards / Debit Cards
Real Estate Loans
Internet Page

The next step in reviewing the EDP system is to assess management controls.

What are management controls and how do you assess them?

21.04 You need a general understanding of how the credit union manages the EDP operation. The review of management controls will address the following areas:

- a) Organization.
 - b) Planning for Growth.
 - c) Contracted Services.
 - d) Disaster Recovery.
-

The credit union should have a well-defined organizational structure that identifies the EDP role in the credit union. As the credit union grows, so will the EDP function. Senior management's plans for credit union growth should include requirements for upgrading the EDP system as necessary. Identify key contracting concerns as related to the computer operations and develop procedures to ensure that management addresses the concerns. The contracting for service should follow the credit union contracting requirements plus have additional requirements related to EDP concerns. Finally, there should be a disaster recovery plan that will include the recovery of the computer system should a major disaster occur.

Could you discuss organizational management controls?

21.05 The objective of this review is to identify the various parts of the computer operation and identify staff responsible for those parts in an organization chart.

The computer system must meet certain requirements to fulfill the ongoing processes of receiving data input, processing the data, and generating reports. The difference between a small credit union and a large credit union is the complexity of the required software and hardware necessary to perform and support these functions. Therefore the required organizational structure of the EDP function would follow similar lines between large and small credit unions. So even though a small credit union does not have a separate DP function, it is necessary to document the EDP organizational structure.

Identify the different operating points of a computer system. Correlate operating points to personnel who are responsible for the various parts of the computer operation. The operating points to be identified are:

- Overall Operation of the Computer System.
 - Computer Software/Hardware Upgrade.
 - Data Input.
-

- Data Output.
- Data Reconciliation.
- Programming.
- System Backup.

Someone is responsible for each of the items with respect to the computer system. You should develop an organization chart identifying who is performing each of these functions. Attached to the organization chart, you should provide a job description of all personnel identified. There should be a clear separation of duties based on the organization chart.

In a small credit union where one or two people are performing the above functions it might be appropriate for you to verify the backup and data reconciliation process quarterly. You do this by:

- Being present during the process.
- Verifying the reasonableness of the process.
- Checking/testing the log of backups and data reconciliations.

The organization chart should clearly demonstrate separation of duties. In the small credit unions where this is not reasonable, you should provide a footnote to the organization chart. The footnote should identify the additional procedures you used to offset this control issue. If you have hired an outside EDP auditor, complete this process and provide it to the EDP auditor.

What management controls should we look for relevant to planning for growth?

21.06 The credit union's computer system is not an unlimited resource. Software usually has a limit as to the number of records it can process. The computer system will slow down as data input into the system increases, based on the processor speed and complexity of programs used. Hard drives have limited space. Serious consequences could occur should the hard drive run out of

space on a busy afternoon.

Planning for computer growth along with credit union growth will prevent these types of problems. Management should also question the status of computer resources when planning credit union growth. Your audit should ensure that proper computer information is being provided so that the credit union Board can make correct decisions in planning for the credit union's growth.

You need to verify that the credit union has identified acceptable criterion for key resources of the computer system. Some areas needing consideration are:

- Hard drive capacity.
- Data access speed for reports.
- Wait time for data input/screen queries.
- Batch processing time.

The credit union can set guidelines based on the hardware and software limitations. For example, if the hard drive usage reaches 80%, personnel should order a spare hard drive. Installation of the additional drive should occur at the 90% mark. Bulleted items 2 through 4 listed above require time frame criteria so the following are identifiable:

- Ideal response time.
- Acceptable response time.
- Unacceptable response frame.

You should ensure that someone is monitoring these criteria. A rapidly growing credit union could require monthly checks of these items. If the credit union is growing very slowly, verification once a year would be adequate. Your EDP audit should verify the reasonableness of the goals and that they are being monitored relative to credit union growth. Finally, planned credit union growth should incorporate expected changes in computer operations and related requirements.

Negative income can be the result of poor planning for computer growth.

What management controls should we look for governing contracted services?

21.07 The computer center can have several different areas of contracted services. This is especially true when the credit union is relatively new to computerized systems or is a smaller credit union. However, even large credit unions can require some areas of contracted services. Some of the areas of contracted services are hardware maintenance and programming services. These areas are generally critical to the ongoing operation of the credit union.

The credit union should follow its policy governing contracts. For example, if a credit union contracts for a new office to be built, contractor bonding is required, plans are required, cost limits are defined, legal counsel is obtained, etc. -- Similar criterion applies for contracting computer services. Computerized systems require additional review as described below.

- **Hardware Maintenance.** Credit unions may contract for hardware services when the credit union does not have personnel who are knowledgeable about hardware or where it is too expensive to maintain adequate inventory to perform maintenance system. The additional areas to be reviewed within the contract are:
 - ⇒ Average time frame between call and response,
 - ⇒ Emergency time frame between call and response, and
 - ⇒ Guaranteed up and running time frame.

These time frames should be close to the time frames identified in the EDP survey worksheet. If they are not, the credit union could have some serious problems. A clause reimbursing the credit union for any losses due to the outside service providers exceeding the contracted response time is desirable.

- **Programming Services.** Credit unions may either purchase or contract for ongoing programming services. The cost of maintaining programming staff is prohibitive for medium to small credit unions. The alternative is to:

- ⇒ Contract a programmer to write the program.
- ⇒ Purchase a software package off the shelf.
- ⇒ Contract with a provider of services.

The first concern is whether the software has a report writer. The credit union could save money and time if it could access the data and create one-time reports through the use of a report writer.

The second concern is the ability of the software to generate a common database or file that another software package or provider of services could assimilate. It is time consuming to key in credit union data. Also data input is subject to normal human errors.

The third concern is that the provider of services assist in a change over to another provider of services or an internal program at a set cost per hour for a set period of time after notification. The contract should specify the hourly rate and specific time frame. Assistance after the conversion should continue for a minimum of three of three months. Assistance for six months to a year is preferable. The contract should also require copies of all vendor system audit reports be provided to the credit union.

What management controls should we look for governing disaster recovery?

21.08 Disaster recovery procedures for the computer system are defined as the ability of the credit union computer system to be up and running in a reasonable amount of time when a disaster occurs that affects the system. A disaster, for example, is something that destroys the computer room and everything in it. An example of this is a fire that burns down the credit union office along with the computer. The question that arises is whether the credit union can be up and running in a reasonable amount of time. The *EDP*

System Survey defines the timeframe. The credit union must develop and document procedures that address this concern. The EDP audit needs to verify that this procedure is in process or completed.

The size and location of the credit union will define the extent of any control necessary for an adequate disaster recovery system. The following items are required for the credit union to open for “business as usual” in a reasonable amount of time after a disaster:

- List of current personnel to be notified.
- Offsite location.
- Required hardware must be available.
- Operating systems used by the credit union must be available.
- Programs and data must be available.
- Instructions on how to put this information together.

Most likely, one day is insufficient to complete this process even if all of the above is in place. It will take a concentrated effort by management to ensure all of this data is in place and works.

Your EDP audit should verify that the list of personnel to be notified is current, the offsite location exists, the required hardware is available at the location, and the instructions are appropriate. You should verify the availability of programs, data, and operating system under the *General Controls - Backup Procedures* section of this chapter.

It is very important that you verify that the disaster recovery process works. You can do this by either verifying the process through review of the documentation of the test or being at the offsite location at time of test. There should be a test of the system at least once a year. You should be aware that computer personnel will be performing the tests at the offsite test location until the system functions correctly and they document this

condition. As soon as possible after the backup system has been established, a backup person (i.e. a board member) should perform the tests.

After assuring yourselves concerning management controls, you need to focus on general controls.

Could you give us an overview of general controls?

21.09 General Controls provide an umbrella effect on the total computer operation. They do not relate to a specific application or function but cover the entire system. Good general controls are part of the overall internal accounting control environment. If proper general controls are in place, they will contribute to the safeguarding of credit union assets. General controls cover areas such as:

- System Security.
- Backup Procedures.
- Computer Operations.

The backup process provides the credit union the ability to restore systems that may experience a problem. This is a critical part of the review for credit unions that have data that it cannot restore if the computerized media (i.e. tapes, disks) are destroyed. System security installs physical safeguards to protect the computer and related resources. In addition to the cost of computer hardware there is the cost of replacing the data within the computer. Replacement cost could be very expensive. Computer operations are the processes that run the computer, all software, and controls the output of data. Needless to say if anything goes wrong here, the computer process stops dead in its tracks. The review of this area should ensure that the credit union can quickly restore lost data and also prevent outside interference in the operation of the computer system.

You should diagram the physical layout of the computer operation to efficiently perform this review. You should clearly identify key items. Include the following minimum items:

- a) The computer.
-

- a) The tape backup system and library where applicable.
- b) The control terminal.
- c) Any user that may have access to the control terminal from his or her desk.

You should footnote this workpaper as to your collective conclusion on the reasonableness of these controls. Reference appropriate workpapers.

You should be able to do this review. You may require help during the review of computer operations depending on the complexity of the computer system.

What general controls should we look for governing system security?

21.10 The Board of Directors of the credit union is responsible to determine the importance of records identifying member's ownership in the credit union. The Board of Directors should address the level of security that is acceptable to the credit union. The Board policy should address these areas of security:

- Physical Security.
- Data Security.
- Personnel Security.

These are the areas where someone can cause accidental or intentional harm to either the hardware or the software used by the computer system.

Physical security. Credit unions that locate the data processing system's main database in a separate area should control access to the area by lock and key. Only authorized personnel should have access to this area and adequate protection against fire, theft or other damage to equipment should be in place. The same is true for access to workstations & terminals where practical. The computer system itself should have some tracking mechanism to determine attempts at unauthorized use. Supervisory personnel should monitor this mechanism. Violation reporting procedures

should be in place alerting management of any breach of security.

Data security. Only authorized personnel should access credit union data. This should be on a 'need to know' basis. Each employee should have their own private log-on and password code to log onto the system, and only have access to the necessary area in which they work. Employees should not share access codes between themselves or with others. Supervisory personnel can periodically review access logs to monitor access.

Personnel Security. Separation of duties is one of the most important factors among general controls. Where practicable, individuals' access to applications should be separated by functions such as data input, data processing, and output. Where it is not practical to separate duties a frequent review of transaction logs can compensate to some degree. Also the credit union should make background checks of all personnel that have access to sensitive data or responsibility for operation of the computer system.

You should verify that the credit union:

- Changes locks periodically or when personnel are changed.
- Changes passwords periodically.
- Performs background checks on personnel.

What do you need to know about general controls related to backup procedures?

21.11 Computer backup is the process of duplicating the current data on the computer system. The credit union backup can backup to disk, tape, or CD depending on the requirements of the computer system. With costs of disks and CD duplication coming down in price, more systems are using this type of media for backups. Also disk drives and CD data lasts much longer than data stored on tape.

Depending on the size of the credit union and software requirements per the EDP System Survey, the backup process

may consist of various methods or combinations of media backups. Senior management makes decisions about the time requirements for restoring data. Some of the alternatives are:

- Immediate restoration of data/software.
- Restoration can be by start of business the next day.
- Any combination of these depending on the software.

When the credit union requires the capability of immediate restoration of data, they should make two backups. One backup would go offsite for disaster recovery and the second backup would be maintained onsite should restoration of files or software be needed during the day. In all cases, one copy should be stored offsite. You need to verify that management did make a decision concerning this area and that it is being followed.

You, at a minimum, should verify that the credit union has backed up all software data files and software programs and that it keeps each in a safe place. It is advisable that at least three generations of backups be done of the data files. These backups are daily, weekly and monthly. The credit union should backup program files periodically as tapes and disks can lose their integrity over time. The credit union should also back up program files whenever it makes any changes or upgrades to the system. The credit union should also backup the current version of the operating system.

The credit union should record all backups in a backup log, clearly identifying each backup with: the backup time, backup date and sequence number, and operator information. Someone should clearly label the backup tapes or disks to match the log and place them in a location secure from fire or other threats. It is preferable to store these tapes or disks off site at a location readily accessible such as a vault or storage service. The credit union should clearly document the procedure for restoring files so it is easy to follow, and store it with the outside backups.

It cannot be over emphasized that periodic testing of the restore procedure be done. This is to assure that the backup and restore processes are in fact working properly. The credit union should log

test results with the following:

- Date and time of the test.
- The files tested.
- The name of the operator who performed the test.
- And the results of the test whether successful or not.

Supervisory personnel of the credit union should periodically review this log.

What do you need to know about general controls related to computer operations?

21.12 The operating system is the main system software program that allows communication between the different parts of the computer including both hardware and software programs. Operating system documentation needs to be available and up to date. Some of the areas that you need to review are:

- a) The current version number and name of the operating system.
- b) Whether the credit union has the current version of the operating systems.
- c) How the credit union notifies staff when it changes the operating system..

Management should maintain written procedures for computer operations and update them on a regular basis. These include the scheduling of:

- System maintenance.
- Data output.
- Problem reporting.
- Problem correction.

The computer operator controls the processing of data by the

computer. The computer operator schedules and runs batch programs. Areas of concern as they relate to the computer operator are:

- a) The operator should not originate entries for processing.
- b) Correcting Entries should not be done at the control terminal.
- c) The operator should not do program balancing procedures other than run-to-run controls.

The operating terminal is the focal point of the computer operations and you need to make sure to address all issues.

Finally, there should be an alternate source of power such as an uninterrupted power supply for the main computer system. You should attend the testing of this process and verify:

- a) The computer continues to operate after a power termination.
- b) Low power conditions result in notification to users.
- c) The computer is brought down softly, and
- d) Turning the computer on resulted in a proper restoration of the computer.

After assuring yourselves concerning the general controls, you need to focus on application controls.

What do you need to know about application controls?

21.13 Application controls apply to the processing of data into, through, and out of the computer. Also included in this section are the procedures used to develop, test, and make changes to programs. These procedures ensure:

- a) The program is efficient.
-

- b) Program changes address the user's specific requests.
- c) The program adequately protects the processed data.

These goals are difficult to achieve when several programmers follow their own instincts while developing a program. Programming controls try to ensure that all programmers follow one road to the location defined by the user. Programming standards have a standard routine library so programmers use the same code when needing a common routine. It is necessary to define the program goal so the programmers head in the same direction. If you do not know where you are going you do not need a map to get there. The cost of program development, software maintenance, and program changes is expensive. This is the reason for Application controls.

In any Information Systems environment the integrity of the application software is critical. Errors in data processing due to lack of proper standards in programming or processing can be very costly. It is therefore necessary that you verify that proper standards are set up and adhered to with regard to the following areas:

- a) Programming Standards.
- b) Program Changes.
- c) Data Processing.

The type and complexity of applications should also be an indication of whether you should hire an outside auditor to perform the review. If you are not familiar with a particular system's application software you should consider hiring an outside auditor. Please note that this is one of the more difficult areas to audit.

What do you need to know about application controls related to programming standards?

21.14 The purpose of programming standards is to provide the users assurances that programs developed:

- a) Are created as quickly as possible.
- b) Have standard routines that are consistent in all programs developed.
- c) Use tools that allow the programs to run as efficiently as possible.

Programs used for production are generally in machine language. The programmer writes the program in a language such as COBOL. The program is then compiled into machine language. The computer is most efficient when processing machine language programs. Also it is not possible to alter the program either accidentally or intentionally without the source code and the compiler. The programming languages used today for production programs have compilers.

Your audit needs to verify that the programming staff have the necessary tools to accomplish the tasks and that they use the tools. Also programming standards include instruction on the programming of common routines to ensure consistency between programmers. Some common routines are date manipulation, headings, date stamps, etc. The more advanced programming standards can define how to write the programs. Please note that when a programming shop changes a standard program used, they must develop new written standards.

You need to survey the programming shop to determine the developed standards and the programming tools available to the programmers. Some of the items to check for are:

- Written standards.
 - Program naming standards for development, testing, and production.
 - Library of standard routines.
-

- Program documentation requirements.
- Program testing standards.
- Efficiency test standards or third-party testing programs.
- Program acceptance by user.
- Program documentation filing procedures.

Once you identify the standards, you will need to determine if these standards are reasonable. The workpapers should state clearly which standard(s) needs improvement and the basis of the opinion.

You need to review the use of standards. This will require a sample program(s) be taken and verification of the application of the standards. Discuss with the user, items such as speed of operation and reasonableness of data input, to ensure that the program is running with little or no errors, and was put into production within a reasonable amount of time.

Note: To perform this part of the audit the auditor will need a high level of computer programming skills. The EDP auditor should do this part of the audit.

What do you need to know about application controls related to program changes?

21.15 Over time the environment we work in changes. This will require changes to the programs we use to process data information. Generally we develop one time programs that grow in importance and require us to use them routinely. These programs run against the data we use for production. Also regulations may require a change in the data we need to produce to perform our job. Any of these reasons and others may require the manager of a department to request a change to their production program.

At this point in time the department manager will go to the DP department and request a change to the production program. The DP department will then process this request through their program change standards. You need to get a copy of the DP shop's

standards for changing a production program. Some items to check for are:

- User requirements for defining requests.
- Procedures for assigning job, setting completion time, etc.
- Requirements for working with user.
- Testing requirement -- use of test deck.
- User acceptance.
- Install procedures used by the computer operator.

You need to verify that the requirements comply with program change standards, and that the complete process is documented and incorporated into the current program documentation. You need to test that these standards are being addressed by the programming shop. You need to review a sample of program change requests.

You need to review the program change request log for completed items. Select a sample of a program change for review. At a minimum, you should verify that the following items are addressed:

- a) All changes to programs are documented as to date, type of change, and modules and programs affected.
 - b) In addition the changes need to be user tested before being put into production.
 - c) User and system documentation must incorporate an explanation of the change needs, as appropriate.
 - d) The user signed off that the program adequately addressed the program change requirement.
 - e) The computer operator installed the new program with the change. The program name was correct and reflected the completed program per program naming conventions.
-

What do you need to know about data processing application controls?

21.16 Data Processing Control Review is the audit of a specific application that will include verification that the specific program had standards applied as defined above. In addition, the review will include an analysis of the department's procedures for inputting data, verifying data input, and generating reports.

You will need to review the structure of the department using the application being audited. A useful audit tool is a flowchart of the data flow within the department. The flowchart must easily identify control points. You need to verify that the controls are being used at the points of data input, data processing and data output. At a minimum, verify the following:

- a) Input authorizations, data verification at entry, control totals, where applicable, exist.
- b) Program mechanisms to detect and reject entry errors input into the system.
- c) Authorized personnel should accomplish processing. During processing there should be a reconciliation to input control totals, verification of file access, verification of program access, and of data entry.
- d) Reconcile output to processing totals, visually check data for verification and ensure data is only accessed by authorized individuals.

In conjunction with the above items, if the application interacts with any of the major credit union systems as outlined in the System Survey, the need for good standards cannot be over emphasized. At a minimum, you should ensure the following:

- a) The application should have a complete and current set of program documentation and user documentation.
 - b) The application should include mechanisms for complete audit trails indicating information such as the identification of the user, transaction numbers, and explanation of entry.
 - c) The application should also include mechanisms for error
-

handling and reporting so that personnel can correct problems immediately or track problems to the program or entry source and implement corrective action.

- d) Security mechanisms prevent unauthorized users from accessing the program.

Electronic Funds Transfer. The Federal Reserve Wire System is gradually becoming another medium for money transfers in credit unions. This includes incoming money transfers from the Fed as well as outgoing transfers to the Fed. Credit unions generally use money transfers to transfer funds for investments. Some credit unions are now offering this service to their members in the form of third-party transfers. Credit union members are then able to move their money electronically worldwide.

The Federal Reserve Wire System generally has good controls over the wire transfer system. However, these controls protect the FRB's liability should a loss occur. The credit unions are responsible for the controls over their wire transfers.

You should review the procedures used by the credit union to do a wire transfer. A flowchart of the process will identify key people and controls. After you fully document the system for processing wire transfers, review the following concerns:

Computer Access.

- Computer should be in a restricted area or in a locked room.
- Log-on to the computer should be password restricted.

Audit Trail should be Documented.

- Identify the person requesting the transfer.
 - Identify the employee initiating the transfer.
 - Verify control of passwords for transfers.
-

- Identify the person verifying the wire transfer.
- Verify wire transfer by call-back to members.

Daily Reconciliation.

- FRB and related accounts.
- Daily audit of wires compared to FRB reports.
- Bank reconciliation's done in a timely manner.
- Correspondence confirmation slips compared to wire requests.
- Persons other than personnel involved with the wire transfer function perform the reconciliations.

You should also verify credit union personnel confirm adequate funds in a member account before processing any transfer requests.

Appendix 21-A

Worksheet -- EDP System Survey

See footnote instructions below.

<u>System</u>	<u>Rating</u>	<u>Recreated</u>	<u>Hardware & Operating System</u>
Shares and Loans <u>Contractor:</u>			
Investments <u>Contractor:</u>			
General Ledgers <u>Contractor:</u>			
Payroll <u>Contractor:</u>			
Check Register <u>Contractor:</u>			
Accounts Payable <u>Contractor:</u>			
Inventory / Fixed Assets <u>Contractor:</u>			
ATM machines <u>Contractor:</u>			
Credit Cards / Debit Cards <u>Contractor:</u>			
Real Estate Loans <u>Contractor:</u>			
Internet Page <u>Contractor:</u>			

Rating: 1 = 1/2 day, 2 = 1 day, 3 = 1 week, 4 = 1 month (How long credit union can afford for the system to not work)

Recreated: If electronic data is destroyed can it be recreated - Yes or No

Hardware & Operating System: e.g. IBM 390 - MVS, IBM-PC Pentium - Windows 95, or LAN Server (Dell 4050 / XE) - Window NT or Novell 3.12, etc.

Contractor: Software provider (e.g. Fedcom, programmed in house, etc.)

Chapter 22 -- WHAT OTHER AUDIT CONSIDERATIONS DO WE NEED TO ADDRESS?

- 22.01 Do we need to review for compliance with regulations?**
- 22.02 Who controls regulations, and monitors for compliance?**
- 22.03 How do we review for regulation compliance?**
- 22.04 What are the primary regulations affecting credit unions we need to know about?**
- 22.05 Are there any repercussions from lack of compliance?**
- 22.06 What resources are available to learn more about regulations?**
- 22.07 What types of security devices should the credit union have?**
- 22.08 Are we responsible for detecting fraud?**
- 22.09 What signs of fraud should we look for?**
- 22.10 What should I do if I suspect fraud?**

Appendix

22-A *Enforcement Responsibility For Laws Affecting Credit Unions.*

Do we need to review for compliance with regulations?

22.01 Yes, you need to review for compliance at least to a limited extent. All officials of the credit union should be familiar with the current regulations governing credit unions.

Who controls regulations, and monitors for compliance?

22.02 When Congress passes an act, regulations are issued to implement the act. The NCUA board is responsible for many of the regulations affecting Federal Credit Unions, and related enforcement. In some cases, other agencies are responsible for regulations and compliance.

NOTE: *This Guide is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the Federal Credit Union Act and the National Credit Union Administration Rules and Regulations §715.*

How do we review for regulation compliance?

22.03 You should review for regulation compliance while completing the various phases of the audit.

You need to assess whether the credit union is using industry-standard forms. Standard forms may provide assurance that the credit union complies with most regulations. If the credit union developed their own forms, they should have obtained a legal opinion of their own to support compliance. Of course, staff still needs to complete the forms accurately. You should review how the forms are completed, to ensure that they appear reasonable.

The credit union's most recent examination or audit may address regulation violations. If so, you should ensure that management sufficiently addressed all issues.

What are the primary regulations affecting credit unions we need to know about?

22.04 The primary regulations affecting credit unions are the *Federal Credit Union Act*, and the *NCUA Rules and Regulations*. Many other regulations affect credit unions; some of which we will not address in this chapter.

The following is a list of most of the regulations affecting credit unions. The enforcement authority is set forth in the appendix to this chapter. The NCUA publication *Compliance: A Self-Assessment Guide* is available to assist you to self test your credit union's compliance.

- *Truth-in-Savings* --
 - *Truth-in-Lending* --
 - *Fair Credit Reporting Act* --
 - *Bank Secrecy Act* --
-

-
- *Expedited Funds Availability Act --*
 - *Electronic Funds Transfers Act --*
 - *Equal Credit Opportunity Act and Fair Housing Act --*
 - *Home Mortgage Disclosure Act, Flood Disaster Protection Act, Real Estate Settlement Procedures Act --*
 - *Internal Revenue Service --*

Many state or local regulations may apply as well. The local credit union league or government office can assist you. IRS directives and regulations also apply dealing with the collection and reporting of taxes. The local IRS office can assist you. Ensure that tax liability accounts clear on a timely basis.

Are there any repercussions from lack of compliance?

22.05 Yes. Lack of compliance, in some instances, can result in substantial civil and/or criminal penalties. The officials must pay strict attention to regulations particularly because of the potential penalties.

What resources are available to learn more about regulations?

22.06 The credit union should establish and maintain a current reference library of the various regulations that apply to the services it offers. You could also contact your local league, or a lawyer (particularly if you note problems), for assistance.

What types of security devices should the credit union have?

22.07 You should simply ensure that records and credit union assets are adequately protected. The types of devices will vary with the size and risk of the credit union. All credit unions should:

- a) Lock essential records in a vault, or fire-proof filing cabinets.

- b) Limit access to the credit union, including monitoring who holds keys. Management should change locks if a person with their own keys leaves the credit union.
 - c) Provide locking teller drawers, and limited access to cash-like instruments. Ensure that tellers have bait money, or a similar device.
 - d) Larger credit unions, or those with more risk, may have motion detectors, entrance alarms, and teller alarm buttons. Review to ensure that protection is reasonable.
 - e) Also reference the Chapter 21, "How Do You Review An EDP System?" for additional information on EDP security.
-

Are we responsible for detecting fraud?

22.08 Your audit is not designed to detect fraud. However, you should be aware of possible fraud while conducting the audit.

What signs of fraud should we look for?

22.09 Sometimes fraud may be obvious. However, most fraud is detected by stumbling onto a circumstance that indicates possible problems, and then researching them further.

Keep these "red flags" in mind while conducting the audit.

- a) Reconcilements, transactions or documentation:
 - Are unusual.
 - Are altered.
 - Are excessive.
 - Contain "plugged" figures.
 - Do not foot.
 - Are unreasonable.
-

- b) Poor internal controls, including poor record keeping. Attain this information through your review of internal controls in your planning and other area reviews.
 - This is particularly true with weaknesses in cash controls, or other easily convertible instruments.
 - This is also particularly true if weak controls exist in an environment with disgruntled or needy employees.
 - c) Nervous, aggressive, or unusual behavior by employees.
 - d) No segregation of dormant accounts. A large number of “Do not mail” accounts, with no appropriate explanation. Or a large number of members with unusual addresses or post office boxes.
 - e) Staff do not maintain copies of members’ statements.
 - f) Strong control of an area by a single employee, particularly if the employee’s position would not normally entail such duties.
 - g) Records are not maintained where they should be (particularly if they are maintained at home).
 - h) Unknowledgeable, trusting, inactive or self-serving officials.
 - i) Brief, non-descriptive board minutes; no credit committee minutes or loan officer minutes.
 - j) The following could indicate kiting:
 - Daily account deposits.
 - Multiple checks.
 - Sources of deposits from related personal or business accounts.
 - Checks and deposits are made in round dollar amounts.
-

- Members frequently request account balance.
- Signator and payee are the same person.

A combination of factors presents a larger risk. Remember that these are simply warning signs that trigger the need for greater attentiveness during the audit, or more in-depth review.

What should we do if we suspect fraud?

22.10 You should discuss the situation with management, particularly if you are not certain about what you have found. If you suspect that the manager is involved in the fraud, you should report your results to the Board of Directors immediately.

Ensure that the Board of Directors reports the fraud to the bonding company, and files a Suspicious Activity Report in all cases of fraud. If:

- The fraud is material (it involves upper management, or entails a large amount of funds), OR
- You feel that action taken by the Board of Directors is insufficient to fully address the situation,

then, contact your NCUA Regional Office, your federal examiner or your SSA immediately.

**Appendix 22-A -- ENFORCEMENT RESPONSIBILITY FOR LAWS
AFFECTING CREDIT UNIONS**

APPLICABLE LAWS AND ENFORCEMENT AUTHORITIES:	FCU's	FISCU's	NFICU's
B - Equal Credit Opportunity	NCUA	FTC	FTC
BSA - Bank Secrecy Act	NCUA	NCUA ¹	TREAS
C - Home Mortgage Disclosure Act	NCUA ²	NCUA ²	NCUA ²
CC - Expedited Funds Availability Act	NCUA	NCUA	FED
D - Reserves on Transaction Accounts	FED	FED	FED
E - Electronic Funds Transfer Act	NCUA	FTC	FTC
FCPR - Fair Credit Practice Rule	NCUA	FTC	FTC
FCRA - Fair Credit Reporting Act	NCUA	FTC	FTC
FDCPA - Fair Debt Collection Practices Act	NCUA	FTC	FTC
FDPA - Flood Disaster Protection Act	NCUA	NCUA	FHA/VA
FHA - Fair Housing Act	HUD	HUD	HUD
HIDC - Holder in Due Course	FTC	FTC	FTC
M - Consumer Leasing	NCUA	FTC	FTC
RESPA - Real Estate Settlement and Procedures Act	HUD	HUD	HUD
RFPA - Right to Financial Privacy Act	PCA	PCA	PCA
SSRA - Soldiers and Sailors Relief Act	PCA	PCA	PCA
TIS - Truth in Savings Act	NCUA	NCUA	NCUA
Z - Truth in Lending	NCUA	FTC	FTC

Legend: FED Federal Reserve Board PCA Private Cause of Action
 FHA Federal Housing Administration TREAS Treasury Department
 FTC Federal Trade Commission VA Veterans Administration
 HUD Department of Housing and
 Urban Development

¹ For those FISCU's examined by NCUA.
² Enforcement authority also applies to CUSO's.

NOTE: Although NCUA is not the primary enforcer under some of these regulations, NCUA can take cease and desist action for violations of any law under Title II of the FCU Act.

Chapter 23 -- HOW DO WE REPORT RESULTS?

- 23.01 What are the reporting requirements of Part 715 of the NCUA Rules and Regulations?
- 23.02 What should the audit findings include?
- 23.03 How can we identify reportable conditions for internal controls?
- 23.04 What are some examples of reportable conditions?
- 23.05 What must we do with the report, if anything?
- 23.06 What is our duty after submitting the audit report?
- 23.07 When is it necessary to complete and report audit procedures in addition to the required annual audit?
- 23.08 What audit procedures should we perform in a supplemental audit?
- 23.09 Who should we notify if a fraud or illegal act occurs?

What are the reporting requirements of Part 715 of the NCUA Rules and Regulations?

23.01 At a minimum, you or your designated representative must prepare a written audit report and submit it to the Board of Directors. If an *independent, compensated auditor* performs the audit for you, he/she must also provide a written report on any identified reportable conditions or errors and irregularities he or she may have discovered in the normal course of performing the audit. You need not expand audit work to seek to identify reportable conditions or errors and irregularities, but those conditions found in the normal course of the audit, if any, he/she must report to you in writing.

What should the audit findings include?

23.02 You need to address whether:

- Internal controls are established and effectively maintained to achieve the credit union's financial reporting objectives

NOTE: *This Guide is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the Federal Credit Union Act and the National Credit Union Administration Rules and Regulations §715.*

that must be sufficient to satisfy the requirements of the supervisory committee audit, verification of member's 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.
- Policies and control procedures are sufficient to safeguard against error, carelessness, conflict of interest, self dealing and fraud.

At a minimum, the audit findings should include any exceptions noted concerning:

- the lack of internal controls, 'insufficient accounting records and financial reports,
- failure of staff to follow plans, policies and procedures established by the board,
- or sufficient policies and procedures.

How can we identify reportable conditions for internal controls?

23.03 We designed the internal control checklists in this *Guide* to identify potential internal control weaknesses if the answer to a question is "No". This is a starting point to determine if a weakness exists.

Further review may be necessary to determine if a "No" answer is a reportable condition. For example, smaller credit unions may have a limited staff size that limits the opportunity for sound internal controls to be in place. If employees cannot correct poor internal controls, more involvement from the officials and supervisory committee will be necessary to offset the weak internal controls.

What are some examples of reportable conditions?

23.04 You may see the following items as reportable conditions: (We don't consider this list to be inclusive of *all possible* reportable conditions.)

- Weak internal controls.
 - Insufficient policies or lack of a required policy.
 - Record keeping in arrears.
 - Reconciliation lacking for a balance sheet account.
 - Financial statement preparation in arrears.
 - Missing documentation for expenses.
 - Loan exceptions noted in the review of individual loan files.
-

What must we do with the report, if anything?

23.05 You (the supervisory committee) must give the audit report to the *board of directors*. The board of directors should review the audit report at a board meeting. The audit report should be included in the board meeting minutes. Also, it is beneficial to meet with the *credit union manager or management staff* to discuss the audit findings.

What is our duty after submitting the audit report?

23.06 You should follow up with the manager to ensure that he/she corrects any findings noted in the audit report.

It is advisable to require the board of directors or manager to complete a written response letter that addresses the corrective action completed by the manager. The board should include a written response letter in the board meeting minutes.

You should give the manager a reasonable period of time to correct the findings noted in the audit report.

You should review all areas of concern to ensure that management has corrected the audit findings. Proper follow up is the key to correcting problems noted in the audit report.

When is it necessary to complete audit and report procedures in addition to the required annual audit?

23.07 You may want to make supplemental audits in addition to the annual audit. If a fraud or irregularity occurs, you should complete a supplemental audit or verification.

If a key member of the credit union staff resigns, such as the manager, you should complete a supplemental audit near the last day of the individual's employment.

What audit procedures should we perform in a supplemental audit?

23.08 The safeguarding of assets and related party transactions are the audit issues that you should address. We recommend the following procedures:

- Count cash and reconcile cash to the general ledger.
- Audit and confirm bank accounts.
- Audit and confirm investments.
- Review and inventory major fixed assets.
- Review all loan files for the individual involved, as well as related parties.
- Review loan and share account activity for the individual involved, as well as related parties.
- Review a sample of paid expenses.

Depending on the seriousness of the issue, a verification of member share and loan accounts may be necessary in addition to the above procedures.

Who should we notify if a fraud or illegal act occurs?

23.09 You should follow the guidance provided in *Letter to Credit Unions #96-CU-3* dated March 1996. It requires that you complete a Suspicious Activity Report (SAR).

In addition, if you **aren't certain** that a fraud or an illegal act has occurred, but suspect one **may** have occurred, you should discuss this situation with the credit union's attorney, the NCUA Examiner, and a representative from the surety bond company.

If you **are certain** a fraud or an illegal act has occurred, you immediately notify:

- Local authorities (police).
- Federal Bureau of Investigation (nearest office).
- National Credit Union Administration (NCUA) - Regional Office, or Fraud Hotline (800) 827-9650.
- NCUA District Examiner or SSA.
- Surety bond company.

Prior to taking action against an employee, we strongly recommend you consult with the credit union's attorney.

Chapter 24 -- WHAT MUST A VERIFICATION INVOLVE?

- 24.01** What is an “Account Verification”?
- 24.02** Why must we verify accounts?
- 24.03** How do we send the verification to the members?
- 24.04** When do we complete the verification?
- 24.05** Which accounts do we verify?
- 24.06** What controls do we need to implement for the verification?
- 24.07** How do we get started?
- 24.08** What is the difference between a positive and negative confirmation?
- 24.09** How do we complete the verification?
- 24.10** What additional steps do we need to take for a positive verification?
- 24.11** What is a sample?
- 24.12** What requirements do we need to meet when obtaining a sample?
- 24.13** How accurate would a sample be?
- 24.14** How do we determine the method of selection?
- 24.15** How do we select a sampling plan?
- 24.16** How do we determine precision, confidence level, and occurrence rate?
- 24.17** How do we select a sample?
- 24.18** What do we do with the statements returned as “undeliverable,” or “moved”?
- 24.19** What action is appropriate if we receive a notice of an incorrect balance?
- 24.20** How do we verify closed accounts?

Appendices

- 24-A** *Notice*
- 24-B** *Positive Verification Letter*
- 24-C** *Negative Verification Letter*
- 24-D** *Negative Verification Statement*
- 24-E** *Tables for Use in Statistical Sampling*
- 24-F** *Closed Account Verification Letter*

NOTE: *This Guide is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the Federal Credit Union Act and the National Credit Union Administration Rules and Regulations §715.*

**What is an
“Account
Verification”?**

24.01 An account verification means requesting members to respond to you if the activity or balances on their statements are not accurate. Sometimes a verification is called a confirmation.

**Why must we
verify accounts?**

24.02 Section 115 of the *Federal Credit Union Act* requires you, the supervisory committee, (or your designated representative) to verify the member’s accounts with the credit union’s records at least once every two years. You must verify both the accounts that are currently outstanding, as well as those that members have closed since the prior closed account verification.

The purpose of the verification is to detect errors, and it is also a good control to prevent fraud.

**How do we send
the verification to
the members?**

24.03 You could mail the verification to the members by either independently mailing:

- A confirmation letter to the members; OR
 - The member’s statements of account that includes the verification notice.
-

**When do we
complete the
verification?**

24.04 The date of the verification is at your discretion, as long as you complete it at least once every two years.

You should consider timing the verification to coincide with a month the CU normally mails member statements, to reduce postage and related costs. However, if internal controls are weak, it may be worth the cost involved to send a separate mailing at a date that management would not expect.

You could also consider completing the verification with the annual audit.

Which accounts do we verify?

24.05 You can verify all accounts, in their entirety, or review a statistical sample of all accounts. We recommend that you conduct a verification of all accounts. Verifications are relatively easy, if the credit union's data processing system can assist you.

Refer to the section "What is a sample?" below for information on selecting a statistical sample.

What controls do we need to implement for the verification?

24.06 You should ensure the following controls when conducting the verification:

- a) *Be sure to use your own or another independent address.* This is true of both the return address on the envelope, and the contact person for problems. Some supervisory committees use their outside auditor's, or their own post office box.
 - b) Whenever possible, do not use management or operating staff to prepare and mail the forms, or select the sample. The verification should be completed by you, clerical assistants, or outside professional auditors. In some cases, you may require staff assistance (for example, when an in-house data processing system is used). If so, staff should be well supervised.
 - c) Distribute a general notice to the membership (possibly through your newsletter and posting a notice in the credit union), indicating that the verification is in process. You could also consider posting a notice in the local newspaper. There is little need for the notice if you are using a sample, rather than verifying all accounts. The appendix to this chapter includes a sample notice (page 24-A).
 - d) Select a date for the verification that is unknown to staff. Conducting the verification on a surprise basis allows little time for anyone to adjust or manipulate records prior to the verification.
-

- e) Gather all of the information you need when you arrive. You should maintain control of all records if feasible, possibly conducting the verification after operating hours (such as in a small credit union).
-

How do we get started?

24.07 To begin the verification:

- a) Determine the capabilities available on the computer system, if you are not familiar with them. The amount of notice provided to management will directly relate to the computer services you need. For example, if you want to print a notice on the member's statement, it is necessary to notify management of the verification before they run the statements. Also ensure that member's statements are printed from the same data base used to generate the individual ledger totals -- it is possible to have a system generate different listings from the same computer.

You should ask the following questions:

- Can they print the notice on the member's statements? If so, this is probably the easiest way to complete the verification.
 - Can they select an appropriate sample on the computer system, if applicable (reference the following paragraph)?
 - Does the credit union use an outside processor to print their statements? If so, contact the vendor about two weeks before the verification to set up the process. If you know the vendor, it would be preferable to notify only the vendor (to maintain a surprise verification date, if possible).
- b) Choose the type of verification (positive, negative, or both), and whether you will use a sample. See 24.08, 24.10 and 24.11.
-

You should review the requirements of a sample, if considering this option. Remember that you cannot use a sample if the member share and loan trial balance does not tie to the general ledger. If you are considering a sample, you should verify their accuracy.

If the credit union has weak internal controls (such as in a small operation), you should negatively confirm all accounts, and positively confirm a sample. Remember to include a positive verification if using a sample (as noted above).

- c) Determine whether you will need to print copies of the verification, or obtain a rubber stamp to use on the member's statements. We have included sample verification notices in the appendix to this guide. Print the copies, or order the stamp, if necessary.
- d) If the credit union accepts member's requests to not mail statements, choose an alternate procedure to verify these accounts. The preferable method is to call the members.

What is the difference between a positive and negative confirmation?

24.08 With a positive verification, you send a notice to the member and expect a reply back, regardless of the accuracy of the balance.

With a negative verification, you expect a reply *only* if the balance is incorrect.

Obviously, with a positive confirmation you know that the member received and read the notice. A negative confirmation assumes that accounts are accurate, even if the notice was lost in the mail, or the member did not read it.

Consider conducting a negative verification of all accounts. With the assistance of the credit union's data processing system, negative account verifications are relatively easy. The data processing system can simply print a notice on the member's regular statement.

You must use a positive account verification, IF using sampling,

- When internal controls are weak (such as in a small credit union operation), *AND*
 - For dormant accounts, accounts with unusual activity, and large balance accounts.
-

How do we complete the verification?

24.09 You should complete the following steps:

- a) If you will use a sample of accounts, select the sample (reference the following paragraph for instructions on computing the sample).
 - b) If your system will print the verification notice to members on their monthly statements, closely supervise the staff involved in printing, stuffing and mailing the statements. If internal controls are weak (such as in a small credit union), you should stuff and mail the statements yourselves. Of course, if the credit union uses a vendor to process their statements, the independence provided by the third party greatly reduces the need to maintain supervisory control. Reference the appendix to this chapter for examples of notices.
 - c) Ensure that any statements removed were for “Do not mail” accounts. Maintain a list of these accounts.
 - d) If you will complete the verification without assistance, complete the following steps:
 - Obtain the member’s statements
 - Include the verification with all of the accounts (or those you selected in your sample)
 - Remove all statements for the “do not mail” accounts, and maintain a list of these accounts
 - Stuff and mail the remaining envelopes
-

- e) Verify the “Do not mail” accounts by telephone, or the method previously chosen. If you are not able to contact the member by telephone, after several attempts, review the account history. Are there any unusual transactions? Trace a sample of the transactions in the member’s account. Does documentation appear reasonable? If there are unusual or unreasonable transactions, you should continue to investigate the account and attempt to contact the member.
 - f) Retain a copy of the member share and loan trial balance, and the sample (if used), to document the accounts verified.
-

What additional steps do we need to take for a positive verification?

24.10 You should complete the following additional steps for a positive verification:

- a) Check off accounts as the members return the verifications.
 - b) Review the responses to ensure that there are no discrepancies noted.
 - c) About two weeks after the verification, send a second notice to the members that have not responded.
 - d) About two weeks after sending the second notices, contact the member by telephone. You may need to try several times.
 - e) If you are still not able to contact the member by telephone, review the account history. Are there any unusual transactions? Trace a sample of the transactions in the member’s account. Does documentation appear reasonable? If there are unusual or unreasonable transactions, you should continue to investigate the account and attempt to contact the member.
-

What is a sample?

24.11 Sampling is a process where a representative portion of all of the member's accounts are selected. The purpose is to be able to determine characteristics of the entire population, based on the review of this representative portion.

While sampling is beneficial in some respects, sampling is not necessarily feasible or desirable for every supervisory committee. Smaller credit unions that have a relatively limited number of accounts will undoubtedly find it easier to conduct a complete 100% verification. From a cost, time, and theory standpoint, sampling is not usually advantageous when applied to a relatively small number of accounts.

There are strict procedures that one must follow to determine a sample.

What requirements do we need to meet when obtaining a sample?

24.12 IRPS 80-12 addresses sampling requirements for the verification of accounts. Your statistical sampling *should* include all of the following minimum standards:

- a) An error (occurrence) rate of 0.5%, a precision level of 1%, and a confidence level of 95%.
 - b) A random method of selection that will consist of using:
 - Random number tables without replacement;
 - Random number generators;
 - Systematic selection; OR
 - Cluster selection.
 - c) The following statistical measurement methods:
 - Estimation Sampling for Attributes.
 - Discovery Sampling.
 - d) You must use a positive account verification:
-

- When internal controls are weak (such as in a small credit union operation); AND
 - For dormant accounts, accounts with unusual activity, and large balance accounts.
- e) You must maintain detailed documentation to support the:
- Sampling method used.
 - Random number used to determine the starting point.
 - Method of selection, including the interval used.
 - Precision level.
 - Confidence level.
 - Occurrence (error) rate.

You must retain documentation until you complete the next verification of member's accounts.

You must complete a verification of ALL members accounts if:

- *the sample discloses fictitious or unauthorized transactions within the sample OR*
- *the member share and loan trial balance does not equal the general ledger control account.*

A CPA firm may use any method of controlled random statistical sampling as is consistent with generally accepted auditing standards (GAAS).

Lack of adherence to these sampling guidelines could be interpreted as a violation of the Act or the Rules and Regulations.

How accurate would a sample be?

24.13 Following these specific guidelines could result in a more accurate conclusion than examining all data, *depending on the control involved*. It may be easier to maintain complete control over a sample of accounts, than the entire amount. Strict controls minimize errors and the possibility of hiding fraud.

How do we determine the method of selection?

24.14 Every item in the population must have an equal chance of being selected. To avoid the possibility that the person selecting the sample might influence the selection (consciously or not), you need to use one of the following methods:

- a) Random number tables without replacement
- b) Random number generators (a random selection provided by the computer system)
- c) Systematic selection (select every “Nth” item in a population, following a random starting point)
- d) Cluster selection (Break down the population into subgroups, such as inactive accounts, closed accounts, etc. Then apply the same minimum standards of confidence, precision, and occurrence (error) rate as to the remaining population.)

How do we select a sampling plan?

24.15 You have two options:

- a) **Estimation sampling.** This plan determines the occurrence rate of certain exception characteristics within a population, given prescribed ranges of precision and confidence. A very low occurrence rate is important for your verification.
 - b) **Discovery sampling.** This is the preferred method to search for critical errors. It will locate one exception with a predetermined level of confidence (providing the exception exists with a specified error rate within the population of all members' accounts).
-

How do we determine precision, confidence level, and occurrence rate?

24.16 Precision. The possibility exists that the sample results may not exactly be representative of the population. You can measure and control (through sample design and size) the possibility of any material sampling error, by determining the precision and confidence level. Precision is the range within which the correct value of the population characteristic most probably falls. One expresses precision as a plus or minus from the sample results.

For purposes of the verification, you must limit the precision to *one percent*. This will achieve the highest degree of accuracy reasonably possible.

Confidence Level. Confidence level is the percentage of the time we can expect the sample results to be representative of the population, within the stated range of precision. It measures the reliability of the estimate, and the possibility that the estimated value of the population characteristic lies outside the precision limits of the sample.

For purposes of the verification, the confidence level should not be less than *ninety-five percent*. Again, this will achieve the highest degree of accuracy reasonably possible.

Occurrence (Error) Rate. Occurrence rate is the rate of error within the population.

To ensure the detection of fictitious accounts and manipulation of a member's account, the maximum acceptable occurrence rate will *not be greater than .5 percent*.

How do we select a sample?

24.17 The sampling plan must offer each member's account, open or closed, an equal chance of being selected. The total population needs to include all accounts, including inactive accounts. We recommend the following method.

- a) Determine the population. In our example, we will assume there is a population of 8,000 accounts.
-

- b) Determine the expected occurrence (error) rate. We will use the maximum allowed, or .5%.
- c) Specify the precision and confidence level. We will use the 1% upper precision limit, and a confidence level of 95%.
- d) Determine the required sample size.
- e) We will use "Estimation Sampling"; refer to the appendix of this chapter, Table 1 in Appendix 24E. Read down the column until you find the upper precision limit of one percent. The corresponding sample size is 1,000 accounts.

If you choose to use "Discovery Sampling", use Table 2 to obtain the "reliability factor". Using our confidence level of 95%, and reading across the table, the reliability factor is 3.0%. You compute the sample size as follows:

$$\begin{array}{l} \text{Sample size} = \text{reliability factor} / \text{occurrence rate} \\ \text{OR} \qquad \qquad \qquad = 3.0\% / .5\% \\ \qquad \qquad \qquad \qquad = 600 \text{ accounts.} \end{array}$$

If you do not disclose fraudulent or unauthorized transactions, you can be 95% certain that there are none present (given that no more than .5% of the member's accounts contain such activity).

- f) Select the accounts to be included in the sample. Select the sample using one of the methods discussed above -- random number tables, random number generators, systematic random sampling, or a fully encompassing cluster selection. If your data processing system has the capability of conducting a random sample of all member accounts, this would be the easiest method. Be sure to include ALL accounts in your selection process.

Obtain a copy of the member share and loan trial balance. You may need this to select your sample, *or* to provide documentation of the population. You may need to obtain more than one trial balance (for example, sometimes certificates of deposit are listed on a separate trial balance).

Tie the share and loan trial balance to the general ledger

control accounts, if you have not already done this. If they do not tie, complete a 100% verification of member's accounts. Complete the verification, as noted above.

g) Retain documentation to support your verification. You must retain the:

- Sampling method used.
- Random number used to determine the starting point.
- Method of selection, including the interval used.
- Precision level.
- Confidence level.
- Occurrence (error) rate.

Be sure to retain the list of accounts that you verified. The list will provide evidence that you verified the accounts, and you can use it as a checklist for noting the return of verifications in a positive verification. Also retain the entire share and loan trial balance, to provide documentation of the population you selected the accounts from (you could retain this on a disk).

What do we do with the statements returned as “undeliverable”, or “moved”?

24.18 For all undeliverable statements;

- a) Determine the reason for the return.
 - b) Contact the credit union to find out if they received a current address. If not, wait a few weeks and try again.
 - c) The verification can still be considered valid, provided you exhaust every available means to reach the member. Simply review the statements for unusual or unreasonable activity.
-

What action is appropriate if we receive a notice of an incorrect balance?

24.19 For all statements with a potential discrepancy, complete the following:

- a) Research the reason for the discrepancy with staff. Is it simply a timing difference?
- b) If you discover a credit union error, contact the member to inform him/her of the error. Ensure that the error is corrected immediately.

To evaluate the impact of the error, and need for further research, consider the following questions:

- Does the error have a material impact on the credit union's financial statements?
 - Does the error cause an out-of-balance condition between the member share and loan trial balance, and the general ledger?
 - Was the error intentional or unintentional
 - Was it the result of carelessness or misunderstood instructions?
 - Did it occur frequently?
 - Was the error systematic or random?
- c) If the credit union's records appear accurate, and you are unable to determine how the member came up with the balance he believes is in his account, contact the member. Request an explanation, and research further if necessary.
 - d) Notify the board of directors and your examiner immediately if you:
 - Are unable to resolve the difference.
 - Feel an error is material (through the questions on "b)" above).
 - Suspect possible fraud.

How do we verify closed accounts? **24.20** Closed accounts are verified in much the same manner as the bi-annual verification. We strongly recommend that you verify closed accounts at least every few months. Closed accounts are susceptible to undetected errors and fraud, more so than current accounts. Balances on inactive accounts can be easily transferred to other accounts then closed. Your verification must confirm members know their accounts have been closed. You must verify closed accounts at least with the bi-annual verification.

If you can arrange to automatically receive the closing statements for members each month/quarter, using the statements to send the letter reduces postage costs and saves time.

Your verification steps:

- a) Obtain lists of accounts closed since the previous closed account verification.
 - b) If you do not plan to verify all closed accounts, obtain a sample (reference "How do I choose a sample?" above).
 - c) Develop the number of letters you will need.
 - d) Enclose a letter in each statement, if applicable, while checking the member off of the closed account statement. Or address envelopes using the credit union's address list.
 - e) Mail the letters
 - f) Retain a copy of the closed account lists that indicate the accounts that you verified. This will provide evidence that you completed the verification.
-

Appendix 24-A -- *Verification Notice*

Notice to the members of XYZ Credit Union

The supervisory committee recently distributed a notice to all members, requesting you to verify that the balances listed on (your monthly statement/the verification notice) are accurate. If you did not receive your verification form, or if you find discrepancies on the form, please contact the supervisory committee at:

Mr. Paul Roberts, Chairman
Supervisory Committee
PO Box 123
Anywhere, MT 59404

Appendix 24-B -- Example of a Positive Verification Letter

(USE CREDIT UNION LETTERHEAD)

(date)

XYZ Credit Union
Anywhere, MT 59404

(name and address of member)
Account No.

We, the supervisory committee, are conducting a verification of member accounts, and would appreciate your assistance. Please compare the balances shown below with the corresponding balances shown by your records. Indicate whether your account is correct, then sign and return this form to:

Mr. Paul Roberts, Chairman
Supervisory Committee
PO Box 123
Anywhere, MT 59404

Thank you in advance for your assistance.

Date _____

Share Balance _____

Loan Balance _____

The balances reflected above are correct _____
Your signature

The balances reflected above should be:

Share Balance _____

Loan Balance _____

I have noted the correct balances above _____
Your signature

Appendix 24-C -- Example of a Negative Verification Letter

(USE CREDIT UNION LETTERHEAD)

(date)

Supervisory Committee
XYZ Credit Union
Anywhere, MT 59404

(name and address of member)
Account No.

We are conducting a verification of member accounts, and would appreciate your assistance. Please compare the balances shown below with the corresponding balances shown by your records. If the balances do not agree with your records, please report any differences immediately to:

Mr. Paul Roberts, Chairman
Supervisory Committee
PO Box 123
Anywhere, MT 59404

Thank you in advance for your assistance.

Date _____

Share Balance _____

Loan Balance _____

Appendix 24-D -- *Example of a Negative Verification Statement*

The supervisory committee is verifying member records. Please compare these balances with your records. If they do not agree, please report any differences immediately to:

Mr. Paul Roberts, Chairman
Supervisory Committee
PO Box 123
Anywhere, MT 59404

We will consider the balances correct unless we hear from you within the next 10 days.
Thank you for your assistance!

Appendix 24-E -- Tables for Use in Statistical Sampling

Table for Use in Estimation Sampling

<u>Precision Level</u>	<u>Sample Size</u>
2.4	200
1.6	400
1.3	600
1.1	800
1.0	1,000
.8	2,000

Table for Use in Discovery Sampling

<u>Confidence Level</u>	<u>Reliability Factor</u>
90%	2.3
95%	3.0
96%	3.2
97%	3.4
98%	3.7
99%	4.3

Appendix 24-F -- Example of a Closed Account Verification Letter

(USE CREDIT UNION LETTERHEAD)

(date)

Supervisory Committee
XYZ Credit Union
Anywhere, MT 59404

(name and address of member)
Account No.

Our records reflect that you closed your account, and that we remitted the balance in the account of *(balance) on (date)*. If you did not receive these funds, please contact us at:

Mr. Paul Roberts, Chairman
Supervisory Committee
PO Box 123
Anywhere, MT 59404

Unless you report any differences to us within 30 days, we will assume that this information is correct.

We are always concerned when a member leaves, and would like to offer you the opportunity to contact us with any concerns you may have about the credit union as well. Thank you.

Sincerely,

Supervisory Committee
XYZ Credit Union

(Note to the committee: you could consider using this letter as a survey to find out why members closed their accounts)

Chapter 25 - FINAL AUDIT CHECKLIST

This checklist documents the completion of each main audit area. The supervisory committee member(s) completing each specific area places their initials and completion date in space provided below.

		Completed By:	
CHAPTER	PROCEDURE	Initials	Date
8 - Cash	1. Did you review internal controls for Cash?		
	2. Did you complete audit procedures for Cash, including written confirmation of balances?		
	3. Did you complete work papers for Cash?		
9 - Investments	1. Did you review internal controls for Investments?		
	2. Did you complete audit procedures for Investments, including written confirmation of balances?		
	3. Did you complete work papers for Investments?		
10 - Loans	1. Did you review internal controls for loans?		
	2. Did you complete the audit procedures for loans?		
	3. Did you complete work papers for loans?		

NOTE: This Guide is addressed to the non-professional volunteer in a credit union operating in an elementary data processing environment. Compensated auditors should look to the requirements of the Federal Credit Union Act and the National Credit Union Administration Rules and Regulations §715.

Completed By:			
CHAPTER	PROCEDURE	Initials	Date
11 - A.L.L.	1. Did you review the internal controls for the Allowance for Loan Losses?		
	2. Did you complete the audit procedures for the Allowance for Loan Losses account?		
	3. Did you complete work papers for the Allowance for Loan Losses?		
12 - Fixed Assets	1. Did you review internal controls for Fixed Assets?		
	2. Did you complete audit procedures for Fixed Assets?		
	3. Did you complete work papers for Fixed Assets?		
13 - Other Assets	1. Did you review internal controls for Other Assets?		
	2. Did you complete audit procedures for Other Assets?		
	3. Did you complete work papers for Other Assets?		
14 - Other Liabilities	1. Did you review internal controls over Other Liabilities?		
	2. Did you complete audit procedures for Other Liabilities?		
	3. Did you complete work papers for Other Liabilities?		

		Completed By:	
CHAPTER	PROCEDURE	Initials	Date
15 - Borrowed Money	1. Did you review internal controls for Borrowed Money?		
	2. Did you complete audit procedures for Borrowed Money?		
	3. Did you complete work papers for Borrowed Money?		
16 - Shares	1. Did you review internal controls for Shares?		
	2. Did you complete audit procedures for Shares?		
	3. Did you complete work papers for Shares?		
17 - Equity	1. Did you review internal controls over Equity?		
	2. Did you complete audit procedures for Equity?		
	3. Did you complete work papers for Equity?		
18 - Income	1. Did you review internal controls for Income?		
	2. Did you complete audit procedures for Income?		
	3. Did you complete work papers for Income?		

		Completed By:	
CHAPTER	PROCEDURE	Initials	Date
19 - Expenses	1. Did you review internal controls for Expenses?		
	2. Did you complete audit procedures for Expenses?		
	3. Did you complete work papers for Expenses?		
20 - Related Parties	1. Did you review internal controls over Related Party Transactions?		
	2. Did you complete audit procedures for Related Party Transactions?		
	3. Did you complete work papers for Related Party Transactions?		
23 - Written Report	1. Did you complete a written report for your audit findings?		
	2. Did you submit the written report to the board of directors?		
	3. Did you follow up on the audit findings with management to ensure corrective action?		
24 - Verifications	1. Have you completed a share and loan account verification at least once every two years?		
	2. Did you perform an 100 percent verification or a controlled random statistical sample?		

CHAPTER	PROCEDURE	Completed By:	
		Initials	Date

3. Did you prepare a written report of results whether a separate report or included in the findings of your audit report?		
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GLOSSARY OF TERMS

Accounting system	refers to one of the elements of a credit union's internal control structure, includes the following: Quality of the books and record keeping system; Maintenance of accounting records; Financial reporting system, and Preparation of accurate financial statements.
ACH	refers to an automated clearing house (ACH).
Agreed-upon procedures engagement	refers to the performance by an independent, licensed certified public accountant of an engagement in which the scope is limited to applying specified agreed-upon procedures to one or more specified elements, accounts or items of a financial statement. Such procedures are insufficient to express an opinion regarding either the financial statements taken as a whole, or the specified elements, accounts or items under examination.
Allowance for Loan Losses	refers to a valuation allowance used to record management's estimate of potential loan losses that may occur in the collection of outstanding loans and loan derived assets. The estimate includes a historical reserve amount based on the past history of experienced loan losses, as well as the individual classification of delinquent or other problem loans.
Analytical procedures	refers to one of the categories of substantive tests. Analytical procedures are tests applied to the total recorded amounts and are based on the existence of plausible and consistent relationships among financial statement elements or between financial and non-financial amounts.
Annual audit	refers to a thorough review of records and transactions for the period beginning the first day following the previous annual audit to the effective date of the current audit. The period may cover more or less than a 12 month period. The annual audit is required once each calendar year.

Assets	refers to items owned by the credit union. Examples of assets are loans, cash, investments, fixed assets, etc.
Assets acquired in liquidation	refers to assets which were collateral for a secured loan and are now in the possession of the credit union until sold.
ATM	refers to an automated teller machine (ATM).
Bank Secrecy Act	refers to the Financial Record keeping and Reporting of Currency and Foreign Transactions Reporting Act. This Act requires record maintenance and reporting of certain transactions to the Internal Revenue Service. Refer to Part 748.2 of the NCUA Rules and Regulations. Independent testing for compliance by credit union personnel or outside parties is required.
Budget variance report	refers to a report completed by management which is used to compare actual income and expense results with budgeted amounts.
Compensated auditor	refers to any accounting/auditing professional, excluding credit union employees, who is compensated for performing more than one compensated supervisory committee audit and/or verification of members' accounts, or opinion audit, per calendar year.
Confidential transactions	refers to any business transaction or account of a member which may not be discussed with persons other than the officials of the credit union who are directly involved in the activity or discussion.
Confirmation	refers to a written verification with a person or organization pertaining to an account balance or condition. Examples of confirmation letters are bank/corporate credit union account confirmation, investment account confirmation, borrowing or line of credit confirmation, attorney letter confirmation, and member share/loan account confirmation.
Contingency liability	refers to estimated future expenses which must be accrued for in accordance with generally accepted accounting principles.

Control environment	refers to one of the elements of the internal control structure, includes the following: <ul style="list-style-type: none">• Management policies and plans;• Organizational structure;• Involvement of board of directors, credit and supervisory committees;• Assignment of authority and responsibility;• Personnel policies, and• NCUA Supervisory Examination.
Control procedures	refers to one of the elements of a credit union internal control structure, includes the following: <ul style="list-style-type: none">• Appropriate authorization of transactions;• Sound segregation of duties;• Safeguarding of credit union assets;• Security access level and controls over the EDP system, and• Management/supervisory committee periodic reviews and test checks.
Credit	refers to an entry on the credit union's books/records to reduce asset accounts, increase liability/equity accounts, increase income accounts and decrease expense accounts.
Debit	refers to an entry on the credit union's books/records to increase asset accounts, decrease liability/equity accounts, increase expense account and decrease income accounts.
Deferred credits	refers to income received but not yet earned.
Depreciation	refers to the expense recognized over the useful life of a fixed asset.
EDP	refers to electronic data processing (EDP) or a computerized system. The term for automated credit unions.
Engagement letter	refers to the written engagement of an independent, compensated auditor to perform all or a portion of the scope of a supervisory committee audit.

Financial statements refers to a presentation of financial data, including accompanying notes, derived from accounting records of the credit union, and intended to disclose a credit union's economic resources or obligations at a point in time, or the changes therein for a period of time, in conformity with GAAP or RAP, as defined herein. Each of the following is considered to be a financial statement: a balance sheet or statement of financial condition; statement of income or statement of operations; statement of undivided earnings; statement of cash flows; statement of changes in members' equity; statement of assets and liabilities that does not include members' equity accounts; statement of revenue and expenses; and statement of cash receipts and disbursements.

Fixed Assets refers to tangible assets such as land, building, furniture, fixtures, equipment, building/leasehold improvements, as well as lease payments, as defined in Part 701.36 of the NCUA Rules and Regulations.

GAAP is an acronym for "generally accepted accounting principles" which refers to the conventions, rules, and procedures which define accepted accounting practice. GAAP includes both broad general guidelines and detailed practices and procedures, provides a standard by which to measure financial statement presentations, and encompasses not only accounting principles and practices but also the methods of applying them.

GAAS is an acronym for "generally accepted auditing standards" which refers to the standards approved and adopted by the American Institute of Certified Public Accountants which apply when an "independent, licensed certified public accountant" audits financial statements. Auditing standards differ from auditing procedures in that "procedures" address acts to be performed, whereas "standards" measure the quality of the performance of those acts and the objectives to be achieved by use of the procedures undertaken. In addition, auditing standards address the auditor's professional qualifications as well as the judgment exercised in performing the audit and in preparing the report of the audit. Copies of GAAS may be obtained from the AICPA, Order Department, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881, telephone (800) TO-AICPA or (800) 862-4272.

General Ledger	refers to the record of final entry on the credit union's books. The general ledger contains summaries of all transactions which affect, assets, liabilities, retained earnings, income and expense. The general ledger is also the source of information for the monthly financial statements.
In-house draft account	refers to an internal share draft (checking) account used by a credit union to issue checks for credit union business.
Independence and Independent	means the impartiality necessary for the reliability of the compensated auditor's findings. Independence requires the exercise of fairness toward credit union officials, members, creditors and others who may rely upon the supervisory committee audit report.
Internal controls	refers to the process, established by the credit union's board of directors, officers and employees, designed to provide reasonable assurance of reliable financial reporting and safeguarding of assets against unauthorized acquisition, use, or disposition. A credit union's internal control structure consists of five components: control environment; risk assessment; control activities; information and communication; and monitoring. Reliable financial reporting refers to preparation of financial statements that "present fairly" the financial position of the credit union and results of its operations and its cash flows, in conformity with GAAP or RAP, as defined herein. Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition refers to prevention or timely detection of transactions involving such unauthorized access, use, or disposition of assets which could result in a loss that is material to the financial statements.
Investments	refers to excess funds (not loaned out) which are purchased to obtain income-producing assets. The specific types of investments a credit union may purchase are listed in Section 107 of the Federal Credit Union Act and Part 703 of the NCUA Rules and Regulations.
Journal and Cash Record (JCR)	refers to the records or books of original entry. The financial transactions of the credit union are recorded each business day in this record. In manual credit unions the JCR is used to record all transactions. In automated credit unions, the general ledger is used to record all transactions.
Judgmental sampling	refers to non-statistical sampling. The sample is selected using one's judgment.

Liabilities	refers to amounts which the credit union owes to others, such as Accounts Payable, Borrowed Money, Taxes Payable. etc.
Licensed, certified public accountant	refers to an accounting/auditing professional who has received a certificate and license from a duly-appointed state licensing authority to practice accounting/auditing, and is independent as defined herein.
Loan Exceptions	refers to incorrect practices, incomplete documentation, missing documents, poor lending practices, violations of loan policy or violations of the NCUA Rules & Regulations noted during the review of loans.
Manual credit union	refers to a non-automated credit union. A credit union without an electronic data processing (EDP) system.
Materiality	refers to a statement, fact or item, which, giving full consideration to the surrounding circumstances as they exist at the time, it is of such a nature that its disclosure, or the method of treating it, would be likely to influence or to make a difference in the judgment and conduct of a reasonable person.
Non-post draft account	refers to a general ledger account (accounts receivable) used to record member share drafts which have not properly cleared.
Note Payable	refers to a loan note given to the lender for funds borrowed by the credit union. The total owed by the credit union is recorded on the general ledger account Notes Payable.
Off-line loans	refers to loan balances (accounts) not on the credit union's main electronic data processing (EDP) system.
Opinion audit	refers to an examination of the financial statements performed by an independent, licensed, certified public accountant in accordance with GAAS. The objective of an "opinion audit" is to express an opinion as to whether the financial statements of the credit union present fairly, in all material respects, the financial position and the results of its operations and its cash flows in conformity with GAAP or RAP, as defined herein.
OREO	refers to other real estate owned (OREO). An OREO is real estate property which has been foreclosed by the credit union and is recorded as an asset pending liquidation.

Random statistical sampling	refers to a sampling which offers objective criteria, based on probability, for determining sample size and evaluating the results of a sample.
RAP	is an acronym for “regulatory accounting practices” which refers to the conventions, rules, and procedures governing accepted accounting practices, other than GAAP, for credit unions and having the substantial support of either the NCUA or the applicable state credit union supervisor.
Reconciliation	refers to the document or schedule prepared to bring into agreement two separate balances. The general ledger account balance is brought into agreement to supporting documentation/records.
Related party transactions	refers to transactions among or between parties where one party controls or can significantly influence the management or operating policies of the other so as to prevent the other party from pursuing exclusively its own interests. Examples of related parties include: executive management, board members, supervisory committee members, credit committee members, employees, and family members of these groups. Examples of “related party transactions” include: interest-free loans or loans at below market rates; sale of real estate significantly below appraised value; nonmonetary exchange of property; below market fees, and making of loans lacking scheduled terms for repayment.
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.
Reserves	refers to portions of earnings allocated for use for a specific purpose, such as the Regular Reserve and the Allowance for Loan Losses account.
Specified elements, accounts or items of a financial statement	refers to accounting information that is a part of, but significantly less than, a financial statement. These may be directly identified in a financial statement or notes thereto; or they may be derived from a financial statement by analysis, aggregation, summarization, or mathematical computation.

Substantive testing	refers to testing of details and analytical procedures to detect material misstatements in the account balance, transaction class, and disclosure components of financial statements.
Supervisory committee	refers to a supervisory committee as defined in Section 111(b) of the Federal Credit Union Act, 12 U.S.C. 1786(r). For some federally-insured state chartered credit unions, the “audit committee” designated by state statute or regulation is the equivalent of a supervisory committee.
Supervisory committee audit	refers to an examination of specified elements, accounts or items of the credit union’s financial statement to the full extent required in this part. An opinion audit as defined herein exceeds the requirements of a “supervisory committee audit.”
Supplemental audits	refers to audits or audit procedures completed in addition to the required annual audit. For example, supplemental audits may be performed after a manager resigns or is terminated.
Surety bond coverage	refers to the protection by a surety bonding company which provides for the recovery of losses by the dishonesty of an employee or official or by the failure of employees to faithfully perform their duties. The specific losses that will be restored by the bond are listed in the written contract with the surety company.
Suspense accounts	refers to general ledger accounts used for unposted transactions until the transactions are posted to member’s accounts. Suspense accounts may be established for: unposted insurance premium withdrawals, unposted share drafts, unposted payroll deposits and transfers, unposted automated clearing house transactions, and unposted automated teller machine transactions.
Test check	refers to a review of a <i>sample</i> portion of activities, rather than <i>all</i> of the activities.
Test of balances	refers to one of the categories of substantive tests. Test of balances are procedures applied to the individual items that compose an account balance or class of transactions. The tests involve confirmation, inspection, or observation procedures to provide evidence about the recorded amount. Test of balances provide stronger evidence and are more effective.

Trial balance of general ledger	refers to the listing of debit and credit balances for all credit union general ledger accounts. The sum of the debit and credit balances should be equal.
Trial balance of member share and loan accounts	refers to the listing of all member share and loan account balances and other information fields relating to account information. The trial balance of member share and loan accounts are commonly produced in numeric or alphabetical order. The total of the member share and loan accounts are reported on the summary page at the end of this report.
Undivided Earnings	refers to the portion of the accumulated earnings of the credit union which are available for the payment of dividends.
Verification	refers to the comparison of one record to another to determine the accuracy of the records. For example, one may compare a member's record of share and loan balances with the credit union's record of share and loan balances.
Verification of member accounts	refers to the procedure employed by the supervisory committee which verifies the accuracy of share and loan balances recorded on the credit union's records. By regulation, a verification must be performed at least once every two years.
Working papers	refers to the principal record, in any form, of the work performed by the auditor and/or supervisory committee to support its findings and/or conclusions concerning significant matters. Examples include the written record of procedures applied, tests performed, information obtained, and pertinent conclusions reached in the engagement, proprietary audit programs, analyses, memoranda, letters of confirmation and representation, abstracts of credit union documents, reviewer's notes, if retained, and schedules or commentaries prepared or obtained by the independent, compensated auditor.

SUPERVISORY COMMITTEE GUIDE – MINIMUM PROCEDURES

Foreword

This Appendix presents minimum procedures which a supervisory committee or its independent accountant or other accountant must complete when a Supervisory Committee chooses the Supervisory Committee Guide option for completing its annual audit requirement under Part 715 of the NCUA Rules and Regulations (Part 715).

This Supervisory Committee Guide option may not be adequate for all credit unions; it is designed for small credit unions. If the credit union is of a larger asset size or higher level of complexity, the supervisory committee should consider a higher level of engagement either: an opinion audit of the financial statements; an examination of internal controls over call reporting; or an opinion audit of the balance sheet only; all performed by a licensed individual. NCUA or the appropriate state supervisor will be evaluating the adequacy of the supervisory committee audit in its annual examination including the level of engagement the supervisory committee chooses to meet its requirements under Part 715.

The supervisory committee, its independent accountant or other accountant may also need to perform additional procedures to supplement these minimum procedures if the specific circumstances of a particular credit union so dictate. The supervisory committee must apply its judgment in determining the procedures necessary to meet Guide requirements. By publishing this Appendix, NCUA is not representing that a supervisory committee which performs or has performed these minimum procedures, and these procedures only, will have fully meet the requirements of Part 715. The committee remains responsible to ensure that a complete set of procedures is performed.

Any time the procedure includes making a selection, the supervisory committee's report, its independent accountant's report or other accountant's report on minimum procedures should delineate the method of selection and the number of selected items. Additionally, because the independent accountant takes no responsibility for the sufficiency of the procedures in an minimum procedures engagement, he or she may need to consult with the supervisory committee about the number of items selected for testing and the selection criteria.

The testing dates should be disclosed in the supervisory committee's report, its independent accountant's report or other accountant's report on minimum procedures.

INTERNAL CONTROL

Teller controls

- Observe that the balancing and replenishment of an ATM is performed by two individuals (on a surprise basis).
- Determine for a selected number [number to be determined in consultation with the supervisory committee] of tellers that access is restricted to their own accounts.

- Obtain a selected number [number to be determined in consultation with the supervisory committee] of individual teller work and verify that all checks and cash items for each day were deposited by the next day by tracing to [describe supporting documentation].

Dormant Accounts (for shares and share drafts)

- Obtain an authorization/privilege report and disclose all individuals who have override authority for dormant accounts.
- If returned member statements are retained, determine that access is restricted and describe the control.
- Obtain a selection [number to be determined by the supervisory committee] of no-mail accounts and verify that a member authorization has been received.

Share File Maintenance

- Inquire if share file maintenance transactions are reviewed / approved by a different individual than the individual initiating the transaction. Report which individual performs the function.
- Obtain a selection [number to be determined by the supervisory committee] of change of address file maintenance forms and perform the following:
 - Trace to the member's written authorization.
 - Trace to proper approval / review.

Wire Transfers

- Obtain the wire transfer authorization record and report who has authority to perform wire transfers. Indicate if these individuals have correspondent account reconciliation responsibility.

BANK RECONCILIATIONS

Obtain a listing of correspondent financial institution accounts, make a selection of those accounts and perform the following procedures:

- Obtain reconciliations of the accounts and compare the balance per the credit union to the general ledger.
- Obtain a written confirmation from the correspondent financial institution for the accounts. Compare the amount on the confirmation to the amount per the correspondent financial institution included on the reconciliation.
- Test the mathematical accuracy of the account reconciliations.
- Determine by reference to the preparer date included on the account reconciliations that the preparer date was within CU policy (disclose policy).
- By reference to the date beside each reconciling item on the reconciliations, determine whether any reconciling items originated in excess of ___ (number of days to be established by the supervisory committee) days prior to the reconciliation date. Include any such items in the minimum procedures report.

- Make a selection of reconciling items and agree to clearing in subsequent bank statements or [describe specific supporting documentation of resolution.]

TELLER SUMMARY SHEETS

Obtain a listing of teller and vault summary sheets and perform the following procedures:

- If one branch, make a selection of teller and vault summary sheets and compare the totals to the general ledger.
- If multiple branches, make a selection of branches and compare the branch totals to the general ledger. Make a selection of individual teller and vault summary sheets and compare the totals to the branch summary.
- Test the mathematical accuracy of the teller and vault summary sheets selected above.

LOANS

Reconciliation

Compare the balance of loans and accrued interest receivable on the loan subsidiary ledger to the general ledger. If the amounts do not agree, obtain a CU prepared reconciliation of the loan subsidiary ledger to the general ledger and

- 1.) Test the mathematical accuracy of the reconciliation,
- 2.) Compare the amount reported as the subsidiary ledger balance for both loan principal and accrued interest receivable to the subsidiary ledger,
- 3.) Compare the amount reported as the general ledger balance to the general ledger
- 4.) Make a selection of reconciling items and compare to [describe specific supporting documentation of resolution.]

Note: The above procedures are to be performed as of the confirmation/ verification date, if applicable.

Approval and processing

Obtain a listing of loans granted during the testing period and make a selection from the listing [the selections should be in proportion to the types of loans granted during the period and the selection should include ___ (number to be determined in consultation with the supervisory committee) related party loans originated during the period]. Obtain the loan application, note, appraisal, title and other documents [describe documents] and perform the following:

- Observe whether approvals are documented in accordance with the CU's loan policy [state policy].
- Determine that a note is on file and signed by the member
- Determine that the collateral for the loan has been recorded otherwise perfected to indicate the Credit Union as lien holder.
- Compare the fair value of the collateral (obtained by the credit union) with the loan amount and determine whether the loan amount falls within the minimum loan to value

requirements included in the CU's loan policy [state policy and indicate the source of the fair value for each loan].

- Compare the interest rate, term, note date, and collateral code included in the original loan documentation to the same terms entered into the computer system.
- Determine if a different individual as evidenced by [describe supporting documentation] is responsible for each of the following functions:
 - Loan approval
 - Loan disbursement
 - Loan processing (input or 'set up the loan' on the subsidiary ledger)

Loan file maintenance

- Obtain the authorization / privilege report and document which individuals have the authority for all three of the following:
 1. To approve loans,
 2. To process loans
 3. For file maintenance
- Inquire if loan file maintenance transactions are reviewed / approved by a different individual than the individual initiating the transaction. Report which individuals performs the review / approval function.

Obtain a selected number of days [to be determined in consultation with the supervisory committee] of file maintenance change reports and perform the following:

- Check for advances of maturity or due dates or address change. For those identified, verify that a modification or extension agreement exists and is signed by the member.
- Trace to proper authorization / review.
- If file maintenance change reports (or a record of changes with appropriate authorization) are not available, disclose in the report.

Delinquencies

Using two consecutive months of delinquency reports, identify a selected number of loans that appear on the earlier delinquency report but not on the later delinquency report.

Document the reason for removal or disposition such as:

- Charged-off (Compare to listings of board approved charge offs)
- Refinanced (Observe new note and state whether or not the principal balance was reduced in the refinancing)
- Payments received (Compare payments received to the member account payment history)

Confirmation/Verification

Make a selection of loans for positive and / or negative confirmation / verification [describe parameters/scope/date] and confirm directly with the member the following: (*Regulatory requirement for performance is every two years.*)

- Current loan amount
- Interest rate

Note: Perform reconciliation procedures as of the confirmation/ verification date.

Accrued Interest Receivable

Make a selection of loans from the loan subsidiary ledger and compare the amount of accrued interest receivable with the terms of the note (and recalculate the amount of accrued interest in accordance with the terms of the note,). For a recent payment, compare the amounts of principal and interest paid to the terms of the note.

ALLOWANCE FOR LOAN LOSSES

Obtain the following documents from the CU:

- Activity in the allowance for loan losses for the testing period which includes beginning balance, provision for loan losses, charge-offs, recoveries and ending balance.
- Detail listings of charge-offs and recoveries by month.
- Management's support of the ALLL calculation which typically includes a listing of rated and classified loans and general reserves.

Perform the following:

- Test the schedules for mathematical accuracy.
- Compare the beginning balance, ending balance and provision expense from the activity schedule to the general ledger.
- Compare the totals on the detail listings of charge-offs and recoveries to the summary analysis of the allowance activity.
- Compare selected monthly charge offs to approvals of such charge offs in the minutes of the meetings of the Board of Directors of the CU.
- Compare the required allowance for loan losses according to the analysis to the amount reported on the general ledger.

Obtain a listing of collateral held in the process of liquidation, which includes both the cost and market value of each item of collateral and perform the following procedures:

- Test the schedule for mathematical accuracy
- Compare the total on the listing to the general ledger
- Identify from the schedule any items for which the cost exceeds the market value and determine that the collateral is recorded in the general ledger at the lower of the two values.
- Determine that the items were transferred from loans to collateral in process of liquidation at estimated fair value by reading internal documentation and agreeing any losses to the detailed listing of charge-offs.

Make a selection of assets sold and compare the cash proceeds to the book value of the collateral in process. Compare the difference between the book value and cash proceeds to the recording in a general ledger gain or loss account.

REGULAR RESERVE, UNDIVIDED EARNINGS AND RESERVES FOR CONTINGENCIES

Obtain monthly activities of the regular reserve, undivided earnings and reserves for contingencies accounts for the testing period and perform the following:

- Make a selection of monthly earnings transfers made by the CU and perform the following:
 - Compare the transfer to the Credit Union's calculation of the amount to be transferred.
 - Test the mathematical accuracy of the computations in the Credit Union's analysis.
 - Compare amounts reported in the calculation to supporting general or subsidiary ledger reports.
 - Determine that the Credit Union's computation is in compliance with applicable regulation.
- Compare net income for the year to the related transfer to undivided earnings.

INVESTMENTS

Obtain a schedule or subsidiary ledger of investments by type and classification (HTM, AFS or trading) from the CU which includes, by security, par value, cost basis, fair market value, unrealized gains (losses), purchase date, maturity date and interest rate and perform the following:

- Test the schedule for mathematical accuracy.
- Compare the total balance of investments and accrued interest receivable on the listing or subsidiary ledger to the general ledger. If the amounts do not agree, obtain a CU prepared reconciliation of the listing or subsidiary ledger to the general ledger, test its mathematical accuracy and compare the amount reported as the subsidiary ledger balance for both investments and accrued interest receivable to the subsidiary ledger and compare the amount reported as the general ledger balance to the general ledger. Make a selection of reconciling items and compare to [describe specific supporting documentation of resolution.]
- Compare the total balance of unrealized gains and losses on securities designated as available for sale to the related equity account.
- Make a selection of investments and compare the market value per the listing or subsidiary ledger to an outside market value provided by the CU (of which such sources may include broker advices, the Wall Street Journal, corporate credit union quotes etc.).
- Make a selection of securities and compare the accrued interest receivable balance to the terms of the security (recalculate the amount of interest receivable in accordance with the terms of the security). Also, recalculate the most recent interest coupon received and

compare it to the credit entry on the general ledger account for accrued interest receivable.

- Inquire if different individuals perform the following functions. Report which individuals perform these functions.
 1. Authorization of the purchase or sale
 2. Accounting for investments (including general ledger and subsidiary ledger record keeping)
- Observe that securities on hand are kept under dual control.

Obtain a listing of investment purchases during the testing period, make a selection and perform the following:

- Compare the terms [define terms in policy] of the investment with CU investment policy, and note terms that deviate from CU policy. [State in the report on minimum procedures the terms that were compared.]
- Compare investment information to documentation of approval [when approval is required by policy].
- Obtain the related broker advice and compare CU's name, the par value, purchase price, interest rate and maturity date to the listing or subsidiary ledger described in the preceding procedure.
- Trace the purchases and sales to the minutes (of the appropriate committee).

For all investments purchased during the testing period (and still owned as of the testing date) and for a selection of investments purchased in prior years, obtain written confirmation from the safekeeper or custodian of the par value, interest rate and maturity date of investments owned by the CU.

If the held to maturity ("HTM") portfolio exceeds 10% of total assets at the testing date, obtain a listing of HTM securities from the previous and current testing dates. Using the listing from the previous testing date as a source, select those securities maturing beyond the current testing date. For those items selected, compare those securities to the list as of the current testing date (i.e., have not been sold or transferred).

SHARE ACCOUNTS

Reconciliation

Compare the balance of share accounts and accrued interest payable/dividends on the share accounts subsidiary ledger to the general ledger. If the amounts do not agree, obtain a CU prepared reconciliation of the share accounts subsidiary ledger to the general ledger and

1. Test the mathematical accuracy of the reconciliation,
2. Compare the amount reported as the subsidiary ledger balance for both share accounts and accrued interest/dividends payable to the subsidiary ledger,
3. Compare the amount reported as the general ledger balance to the general ledger, and

4. Make a selection of reconciling items and compare to [describe specific supporting documentation of resolution.]

Note: The above procedures are to be performed as of the confirmation / verification date, if applicable.

Overdrafts

As of a testing date, obtain a listing of negative share and share draft accounts. Include in the report on minimum procedures each negative account balance that has been outstanding in excess of ten days or in an amount in excess of the share draft policy.

Confirmation / Verification

Make a selection of share accounts for positive and / or negative confirmation / verification [describe parameters/scope/date] and confirm the following directly with the member:
(Regulatory requirement for performance is every two years.)

- Current account balance
- Interest rate (if applicable)
- Maturity date (if applicable)

Note: Perform reconciliation procedures as of the confirmation/ verification date.

Accrued Interest Payable

Make a selection of share accounts from the current subsidiary ledger and compare the amount of accrued interest payable or interest paid on the most recent payment date with the terms of the share account (recalculate the interest amount in accordance with the terms of the share account).

OTHER ASSETS/LIABILITIES

Obtain a listing of suspense or clearing accounts, make a selection of those accounts and perform the following procedures:

- Obtain reconciliations of selected accounts and compare the balance per the credit union to the general ledger.
- Test the mathematical accuracy of the reconciliation.
- By reference to the date beside each reconciling item on the reconciliations, determine whether any reconciling items originated in excess of ____ (number of days to be established by the supervisory committee) days prior to the reconciliation date. Include any such items in the minimum procedures report.
- For a selection of items, compare the disposition to supporting evidence (describe evidence observed).

BOARD MINUTES

Obtain Board of Directors minutes for the testing period. Make a selection (number to be determined by Supervisory Committee) of monthly meetings and determine that the following activities were reported to or approved by the Board of Directors:

- Interest rate changes for loans
- Interest rates for share accounts
- Investment, Asset/Liability Management and Loan policies (annually)
- Delinquent loan reports
- Loan charge-offs

Appendix 8F -- CHANGE FUND RECAP FORM

<input style="width: 100%;" type="text"/> Federal Credit Union Change Fund Recap Date of cash count: <input style="width: 100%;" type="text"/> Audit date: <input style="width: 100%;" type="text"/>

Teller no.	Cash counted	Change fund amt	Difference Over or (short)

Totals	<input style="width: 100%;" type="text"/>	<input style="width: 100%;" type="text"/>	<input style="width: 100%;" type="text"/>
Balance per G.L.	<input style="width: 100%;" type="text"/>		
Difference	<input style="width: 100%;" type="text"/>		

Compare total cash counted with the respective general ledger account balance for the effective date of the count.

If there is a significant difference between the change fund counted and the general ledger balance, include this in your audit report.

APPENDIX 10B -- TRIAL BALANCE OF INDIVIDUAL LOANS

Credit Union:	Audit Date:
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A. CURRENT BALANCES

	TOTAL LOANS
General Ledger balance for total loans:	<input style="width: 100%;" type="text"/>
Sum of individual accounts from the Trial Balance(s):	<input style="width: 100%;" type="text"/>
Potential adjustment/(write-off): [analyze below]	<input style="width: 100%;" type="text"/>

B. ANALYSIS OF DIFFERENCES - Previous 3 Months

	<input style="width: 100%;" type="text"/>	<input style="width: 100%;" type="text"/>	<input style="width: 100%;" type="text"/>
From the Trial Balance(s):	<input style="width: 100%;" type="text"/>	<input style="width: 100%;" type="text"/>	<input style="width: 100%;" type="text"/>
From the General Ledger:	<input style="width: 100%;" type="text"/>	<input style="width: 100%;" type="text"/>	<input style="width: 100%;" type="text"/>
Gain(Loss):	<input style="width: 100%;" type="text"/>	<input style="width: 100%;" type="text"/>	<input style="width: 100%;" type="text"/>

Describe actions by staff to correct differences shown in Sections A and B:

ALLOWANCE FOR LOAN LOSSES

Credit Union: <input style="width: 95%; height: 20px;" type="text"/>	<input style="width: 95%; height: 20px;" type="text"/> Audit date
--	---

Transaction Month	Charge-offs	Recoveries	PLL Adjustment	Misc. (DR) and CR	Balance	Comments
Begin at date of your last audit, record monthly through the current date:						
JAN						
FEB						
MAR						
APR						
MAY						
JUN						
JUL						
AUG						
SEP						
OCT						
NOV						
DEC						
JAN						
FEB						
MAR						
APR						
MAY						
JUN						
JUL						
AUG						
SEP						
OCT						
NOV						
DEC						

Totals:

--	--	--	--	--	--

Balance of the A.L.L. (Account No. 719):

Difference:

Describe actions by staff to correct difference:

TRIAL BALANCE OF INDIVIDUAL SHARES

Credit Union:	Audit Date:
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A. CURRENT BALANCES

	TOTALSHARES
Sum of individual accounts from the Trial Balance(s):	
General Ledger balance for total shares:	
Potential adjustment/(write-off): [analyze below]	

B. ANALYSIS OF DIFFERENCES - Previous 3 Months

From the Trial Balance(s):			
From the General Ledger:			
Gain(Loss):			

Describe actions by staff to correct differences shown in Sections A and B:

REGULAR RESERVE TRANSFERS

Credit Union: <input style="width: 90%; height: 15px;" type="text"/>	Audit date <input style="width: 80%; height: 15px;" type="text"/>
Completed by: <input style="width: 90%; height: 15px;" type="text"/>	

PART A - Calculating the Risk Assets

PERIOD ENDING:

STATUTORY RESERVES:

Pre-Closing Regular Reserve	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
PLUS: Allowance for Loan Losses	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
LESS: Provision for Loan Losses Expense	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
<i>ADJUSTED RESERVES: (A)</i>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>

TOTAL ASSETS:

Assets per Balance Sheet	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
PLUS: Allowance for Loan Losses	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
<i>GROSS ASSETS:</i>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>

LESS: Non-Risk Assets:

Cash on Hand	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
Deposits at Insured Institutions < 5 yrs maturity	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
Assets guaranteed by U.S. Govt. < 5 yrs maturity	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
Loans to other credit unions with < 5 yrs maturity	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
Insured student loans with < 5 yrs maturity	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
Loans insured by Fed/State Govt. < 5 yrs maturity	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
Shares in Corp. CUs with < 5yrs maturity	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
Common trust/mutual fund marked to market	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
Prepaid Expenses	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
Accrued interest on non-risk investments	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
Fully share secured loans	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
Loans guaranteed by NCUA	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
NCUSIF Deposit and Guaranty Accounts	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
Central Liquidity Fund Shares	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
Fixed Assets	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
Investment > 5yrs mat. (lower of cost or market)	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>

TOTAL RISK ASSETS:

(B)

<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
--	--	--	--	--

RISK ASSET RATIO: (A divided by B) (C)

(C)

<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>	<input style="width: 95%; height: 15px;" type="text"/>
--	--	--	--	--

STOP HERE IF THE RATIO IS OVER 6% (NO TRANSFER REQUIRED)

PART B - Calculating the Transfer Amount

PERIOD ENDING:

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GROSS INCOME

--	--	--	--

LESS: Contributions

--	--	--	--

 Non-operating Gain, if included above

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 Income from CLF Investments

--	--	--	--

ADJUSTED GROSS INCOME (AGI) (D)

--	--	--	--

(NOTE TO E&I -- need to set up formulas like in Aires to compute how much should be transferred at 5%/10%.

5% TRANSFER AMOUNT (E)

--	--	--	--

 10% TRANSFER AMOUNT (F)

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REQUIRED TRANSFER (E plus F) (G)

--	--	--	--

ACTUAL TRANSFER (H)

--	--	--	--

OVER/(SHORT) (H minus G) (I)

--	--	--	--

PART C - Verifying Other Closing Entries

You should verify the other required closing entries affecting equity are properly recorded at the same time you are analyzing the reserve transfer activity. The typical closing entries are similar to the following workpaper. Note that negative conditions (a net loss instead of a gain, or reversal of a loss expense) would reverse the credits/debits for these examples.

PERIOD ENDING:

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NET INCOME: (Credit to Undivided Earnings)

--	--	--	--

PLL Expense: (Credit to Undivided Earnings)

--	--	--	--

 (Debit to Regular Reserves)

