NCUA LETTER TO CREDIT UNIONS
NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA 22314

DATE: June 25, 1996
LETTER NO.: 96-CU-4

TO ALL FEDERALLY INSURED CREDIT UNIONS:

SUBJECT: INTERNAL CONTROL STRUCTURE

We are sharing the results of NCUA's review of the 1995 fraud and embezzlement cases with credit union officials so that you can use the results to review your internal control structure and make needed adjustments. Credit unions with limited staff are often at risk of fraud and embezzlement because the critical work is done by few people.

Fraud and Embezzlement Study. Our study involved seven credit unions in which fraud and embezzlement caused the credit unions to fail and service to be lost to many members.

We conducted the study to determine common factors and to develop procedures to detect or minimize the risk of similar occurrences. Unfortunately, once fraud or embezzlement schemes are uncovered, it is often too late to enact corrective measures. Since credit union officials provide the first and most important first line of supervision of the credit union's staff and operations, we encourage the officials to review their credit union's internal control structure and to make adjustments where needed.

Common Factors. You, as officials, can study these internal control weaknesses that are common elements of fraud or embezzlement and make necessary revisions to your credit union's internal controls:

- Lack of board approved policies - for areas such as lending, investing, borrowing, and operating expenses;
- Lack of segregation of duties - concentrating the control over all phases of a transaction in one dominant controlling manager, often a single person operation;
- Lack of mandatory vacation policy - embezzlements usually require the embezzler's ongoing attention; therefore, policies that require managers and employees to take at least one and preferably two weeks' vacation (not a day here and there) reduce the risk of embezzlements;

- Failure to maintain adequate audit trails - audit trails enable the tracing of any given item through the credit union's books;
- Incomplete or inadequate audits or verifications - audits (required at least annually) and verifications (required at least every two years) must be performed in a timely manner, under controlled conditions, and independent of credit union management and staff;
- Inactive supervisory committees - the committee is the most important single element in the internal control structure;

- Repeated record keeping problems - inaccurate or incomplete records are often used to hide fraud;
- Manipulated bank reconcilements - hides problems from casual review;
- Failure to review standard computer reports;
- Fictitious loan or share accounts;
- Concealment of embezzlement using corporate credit union accounts - the nature of corporate transactions is numerous large amounts, therefore, a casual review may not detect fraud;
- Cost of funds far exceeding average stated dividend rates;
- Yield on loans far less than stated loan rate in credit unions with low delinquency;
- Yield on investments well below the coupon rates; and
- Excessive and unexplained operating expense ratio.

Alternative Testing Procedures. Fraud and embezzlement schemes are not solely a problem of larger credit unions. In fact, the very size of small credit unions creates opportunities for a weak internal control structure and fraud. Officials of smaller credit unions must work within their organizations to develop methods that will safeguard their members' accounts and reduce the opportunity for fraud. Suggested reviews and alternative testing methods that the supervisory committee members or someone independent of the credit union staff should perform include:

- Review of the negative shares report;
- Review of unposted items report;

- Review of maintenance reports showing loan due date changes - unwarranted changes to loan due dates may disguise a fictitious loan or loans not receiving regular payments;
- Review of reports showing loans by interest rate - reveals unusually low loan rates;
- Review of general ledger suspense accounts - generally used to temporarily "store" a transaction until all necessary information is available, but can also be used to hide an unauthorized transaction; and
- Review of the reconciliation of cash receipts to cash deposits - daily receipts should be promptly deposited in amounts readily traceable to the bank deposits.

Conclusion. Credit union officials are responsible for implementing a system of sound internal controls and for ensuring that the controls are regularly followed by management and staff. Although fraud may be uncovered, the annual audit and regulatory examination are not intended to detect fraud.

The purpose of internal controls is <u>not</u> to entrap employees; rather, good internal controls provide a working environment in which good employees are not tempted to do something they would not ordinarily do. In smaller credit unions, the supervisory committee often oversees the internal controls, while in larger credit unions, the controls are often monitored by the internal auditing department. Credit unions that initiate and consistently follow basic internal controls are less likely to experience fraud and embezzlement than credit unions whose internal controls are weak.

Sincerely,

/S/

Karl T. Hoyle

Executive Director

EI

(sent by MS-MAIL to all NCUA Staff 6/25/96.)