



**Examination Definition,
Objectives, Scope, and Process**
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For regulatory agencies around the world it is critical to perform on-site examinations for the financial institutions. No one tool is more useful in determining risk than the on-site examination performed by the regulatory body. This examination can be adapted and its scope reduced or expanded based on institutional risk, number of qualified individual available to perform an exam, and monetary resources available.

Full Scope Examination Definition - The examination process is a series of procedures used to determine the economic and financial status of credit unions. Examinations focus on key trends, ratios, management, and operations.

Established examination procedures should provide the examiner with considerable flexibility in tailoring the examination according to the complexity and relative risk of each individual credit union. Examinations are generally performed on an annual basis, but this time frame can be reduced or increased based on credit union risk, identified problems, and/or staffing of the regulatory agency.

During the on-site examination and throughout the period between examinations, the importance of discussing credit union operations with management including goals, plans, policies and internal controls cannot be overemphasized.

Full Scope Examination Objective – Examination has five overall objectives:

- Evaluate the credit union's financial soundness;
- Appraise the quality of management and their adherence to regulations and agreements;
- Determine the asset quality and degree of risk that the credit portfolio poses to the integrity of the credit union;
- Develop plans with officials to correct problems and obtain their approval of the corrective actions; and
- Follow-up with the credit union to ensure timely correction in the areas of concern.

Scheduling Examinations – Examination frequency is scheduled taking into consideration the size and complexity of the credit union and the geographic location. Examiners should consider the following when prioritizing and scheduling examinations:

- Financial conditions and trends in the credit union;
- Potential risk to the integrity of the overall credit union system and risk of loss to an insurance or stabilization fund, if such exists;
- Date of the last examination;
- Information pertaining to the credit union received from outside sources; and
- Number of examiners needed to perform the exam.

Scope of Examination – The examination should concentrate on five major areas of importance. These areas are:

- Analysis of the general ledger;
- Analysis of the loan portfolio;
- Analysis of management capabilities and decisions;
- Analysis of investments; and
- Analysis of liabilities.

The scope of an examination can be flexible and is defined in one of three categories:

1. Reduced;
2. Normal; or
3. Expanded.

Flexible examination scope gives the examiner reasonable latitude in setting the scope and establishing the major areas of review for the exam. The flexible exam allows examiners to perform the examination procedures they deem necessary assess a credit union's operational integrity, financial condition, and the extent to which problems may exist.

When examiners begin the on-site examination process, they should perform the following procedures to gain the information needed to determine the scope of the exam:

- Review the external audit;
- Review financial information and ratio trends;
- Calculate preliminary PEARLS key ratios as of the exam date;
- Review the previous examination results, adherence to agreements between credit union management and regulatory officials and recent correspondence;
- Review written credit union policy and procedure;
- Scan the board minutes;
- Determine if there has been significant changes since the previous exam such as: key personnel changes, significant new programs, decrease in institutional capital, computer system conversion, material changes in the investment or loan portfolio, record keeping problems, lawsuits, and/or regular need for borrowed funds.

Performing these procedures allows the examiner to become familiar with the related policies, procedures, and internal controls while making an initial assessment of risk and determining appropriate examination procedures necessary to test or review a particular area.

The use of reduced scope of work exams depends on the quality of management, the internal audit, external audit, as well as the current economic and financial situation of the credit union. When the initial review of an area indicates that there are no serious problems, the examination should continue with reduced procedures. For example – if problems have been corrected and management is competent and responsible, then the examiner should use minimum procedures on the examination. But, if the reduced exam procedures were used during the previous exam, the examiner should not use the reduced procedures on the subsequent exam. Reduced procedures can not be used two consecutive years. Examiners should expand their scope of work when the initial stage of the exam reveals problems. For example – a rapid rise in the delinquent loan ratio

triggers a more detailed review of delinquent loans to determine the causes for the delinquency, and of current loans to determine whether the problems continue in the recently granted loan portfolio.

A normal full scope examination usually consists of a review of the following operational areas:

- General Ledger and Financial Statements
- Cash Analysis
- Investment Analysis
- Capital Adequacy and Profitability
- Asset Liability Management
- Administration and Management
- Risk assessment of the loan portfolio
- Evaluation of the adequacy of the Provision for Loan Loss account
- Review of the Supervisory Committee work and effectiveness
- Review of Internal Controls
- Member deposits and other debt obligations
- Computer System

Based on the risk assessment addressed above, a reduced scope exam would review each area but the work performed would be reduced as compared to the normal or expanded scope exams. The extent of audit procedures for reduced scope exams are limited to assessing risks in each area and determining that the risk to the financial system and the insurance or stabilization fund, if such exists, are very limited. Expanded scope examinations are used as conditions warrant. If initial examination procedures disclose major concerns in one or more areas, examiners should expand the analysis; completing additional examination procedures to a point in which the extent of the problems can be identified and effective plans for corrective action developed.

Initiation of the Examination Process – Examiners begin planning for an examination before entering the credit union office, and adjust the examination plan as necessary throughout the examination to address problems as they arise. By analyzing qualitative data (including data obtained from recent correspondence, prior examination and supervision reports, and discussions with the prior examiner) and quantitative data (including key trends and ratios and financial statement information) examiners determine if they need to perform additional examination steps.

➤ **Pre-Examination Planning** consists of:

- A review of the credit union file maintained by the regulatory body that should include previous exam reports and correspondence, with the objective of identifying and understanding previous problems, issues, and weaknesses.
- An analysis of financial data from previous periods to identify negative trends and areas of concern.
- A review of the most recent external audit and contacting the auditor to set a meeting to discuss the audit, their workpapers and findings.

- Establishing the date of the examination. The exam may be conducted on a surprise basis or management can be contacted in advance.
- Contacting credit union management (if the exam is not conducted on a surprise basis) to advise them when the examination will start, how many examiners will be there, how long the exam will last and when the exit meeting should be scheduled.
- Preparing a list of reports and information that will be needed to conduct the examination and delivering it to the credit union (if the exam is not conducted on a surprise basis) at least one week prior to the commencement of the exam.
- Notifying team members (if applicable) of location, time, security precautions, anticipated length of exam, and other pertinent information.

➤ **Upon arrival** at the credit union the examiner will:

- Discuss the examination objectives and process with management;
- Ensure that all the information requested prior to arrival is easily accessible;
- Determine the scope of the examination based on the aforementioned review process;
- Select the loan files to be reviewed;
- Obtain the most recent organizational chart so that each examiner participating in the exam knows who they should communicate with based on the work they are performing;
- Obtain a list of the names, account numbers, loans and savings balances of all officials, employees and their immediate family; and
- Determine if any one person or group of people appears to control or dominate the credit union.

Total Analysis Process – In conducting total analysis, the examiner considers both qualitative and quantitative data. The total analysis process consists of six steps:

1. **Collect Data** – The examiner collects financial information from the credit union's accounting records such as the balance sheet and income statement. Qualitative data is gathered through observations, reading board minutes, policies, recent correspondence and prior exam reports, and by discussions with officials and employees.
2. **Review Data** – To review the data the examiner breaks down and reassembles the data, relating the individual parts to the whole, notes all of the positive and negative trends, and evaluates the data.
3. **Interpret Data** – Interpreting the data is the most complex phase of the total analysis process. The examiner should:
 - Inquire about the local economic conditions and other relevant facts not directly available within the confines of the credit union;
 - Listen to employees and officials;
 - Observe the strengths and weaknesses of personnel;
 - Observe the attitudes of the members who transact business at the credit union;
 - Differentiate between important and unimportant data; and
 - Place all of the data in proper perspective.

4. Reach Conclusions – After collecting, reviewing and properly interpreting the data, the examiner arrives at a conclusion. The examiner should identify concerns, explain the causes, and arrive at an institutional rating.
5. Make Recommendations – Recommendations are based on the conclusions reached after analyzing the operation. The recommendations are usually general statements addressing what the credit union should do to overcome the problem.
6. Develop Plans for Action – Well-designed, achievable, and measurable plans for action should correct existing problems and prevent problems from recurring. Since management is responsible for implementing the plans for action, the examiner and officials or key employees should develop the plans jointly. A plan for action should specify:
 - Who will take the action;
 - Description of the action;
 - Start and completion dates; and
 - Which official or group of officials will oversee the action.

The results of the total analysis process are valid only if the examiner considers all pertinent data and interprets it accurately. If examiners have not properly applied the total analysis process, the recommendations and plans for action may not be appropriate. To reduce this possibility the examiner should:

- Make a final review of all data;
- Discuss analysis and conclusions with management;
- Determine that the recommendations and plans for action are practical, specific, and understandable; and
- Determine that the plans will prevent problems from recurring.

Limited Scope or Follow-up Examination – Examinations can also be performed that concentrate on the review of specific areas of concern. These are referred to as limited scope or follow-up examinations. These examinations are a part of overall examiner supervision just as full scope exams are. Supervision is the on-going monitoring of a credit union's financial and operational condition. Examiners supervise the credit unions assigned to their districts as needed through telephone contacts, review of submitted financial information, and follow-up examinations.

To ensure the prompt, effective correction of problems, the examiner who identified the problems and developed plans for corrective action should maintain supervisory responsibilities and perform all follow-up examinations and contacts.

- **The purpose** of follow-up examinations is to:
- Review with management the progress on plans for action to correct previously identified problems and develop additional plans for action for problems identified during the follow-up examination within a reasonable time;
 - Detect emerging financial trends that could threaten the credit union's solvency,
 - Determine the credit union's economic viability and, where necessary, explore other options to continue member service;

- Recommend administrative actions when necessary to protect the interests of the members, creditors, and the insurance or stabilization fund; and
 - Recommend future supervision plans and contact dates.
- **The main difference** between a full scope and a follow-up examination is that the focus is on the problem areas previously identified. Examiners should review the progress made on solving the problems previously identified. They should also identify and document new and evolving problems discovered while performing the exam. Examiners should then amend and/or develop plans for action with the officials to correct unresolved and serious new problems. Upon completion of the follow-up exam, the examiner will hold an exit meeting to update management and the officials on the status of the problems, the recommended corrective actions, and to attain the official's approval of all recommended actions.
- **Scheduling** of follow-up examinations should take into consideration the seriousness of the problem.

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