



## Internal Control Requirements

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Internal controls are mechanisms, policies, and procedures used to minimize and monitor operational risks. In order to deter employees and/or members from committing a dishonest or fraudulent act the controls must be thorough and comprehensive. However, internal controls by themselves are not enough. They will be effective only if they are reinforced by the credit union's culture, policies and procedures, information systems, training, and supervision of staff.

Usually fraud is perpetrated by falsifying or altering documents, embezzling funds, omitting the effects of transactions, recording nonexistent transactions, and/or incorrectly using accounting policies and procedures. Weak internal controls not only allow for the perpetration of fraud but allow for errors and unintentional mistakes to go undetected for a long period of time. Usually, these errors individually do not represent a large amount of funds. However, the cumulative total can be material and the time needed to correct the error significant.

The primary objectives of internal controls are to:

- Safeguard assets and member savings;
- Verify the efficiency and effectiveness of the operations;
- Assure the reliability and completeness of financial and management information;
- Prevent fraud and mistakes; and
- Ensure compliance with applicable laws and regulations.

Internal controls can be broken down into two categories – accounting and administrative controls. These two categories are not mutually exclusive, some of the procedures and records involved in accounting control also apply to administrative control.

**Accounting Controls** - Accounting controls should provide reasonable assurance that staff performs transactions according to management's direction and their authorization level. In addition, transactions should be recorded and financial statements prepared according to accepted accounting principles. A credit union's records must reflect its actual financial condition, structure, and results of operation. Accounting controls may differ with the size and complexity of a credit union. The following controls should be part of the internal control environment and should be helpful both to inform the credit union's board and to enhance managerial effectiveness:

1. Daily Posting – Posting records daily will maintain each day's activities separate and distinct from another day's work. This makes it much easier to locate errors and make corrections. At least monthly, staff must individually prove and balance each general ledger account with its supporting subsidiary ledger, including zero balance accounts with activity during the month.

2. **Subsidiary Records** – No less than monthly accounting staff should balance subsidiary records such as share and loan ledgers, bank and investment statements and individual cashier records with the respective general ledger control accounts. A staff member, other than the preparer of the subsidiary and reconciliations between the subsidiaries and general ledger accounts, should review the periodic reconciliations and document their reviews.
3. **Internal Reports** – Credit unions should design their accounting systems to facilitate the preparation of internal reports (e.g. Non-amortizing Loans, Dormant Savings Accounts, Negative Share Accounts, etc.) necessary to review key areas of operation. A staff member who is not involved in the transactions should regularly review all of the reports. The review of the reports should be documented and any irregularities discussed immediately with a supervisory or general manager.
4. **Recording of Transactions** – All credit unions should use transparent accounting practices that are prescribed by accepted accounting principles to record all their transactions. The recording of transactions should be consistent from one accounting period to the next. Credit unions may not defer expenses or accelerate income for the purpose of manipulating earnings.
5. **Sequential Numbering** – Sequentially numbered instruments used for items such as checks, cash receipt vouchers, journal vouchers, and share certificates assists in reconciling and controlling used and unused items. Credit unions should retain unissued, pre-numbered items under dual control.
6. **Audit Trail** – Credit union records and systems should provide an audit trail (i.e. paper documentation) that allows for the tracing of each transaction from its inception to completion. The documentation should include the name of the individual making the transaction, the date of the transaction, how much it is for, and what general ledger accounts it effects. Some of the more common record keeping deficiencies include:
  - General ledger entries that fail to contain an adequate description of the transaction;
  - Lack of permanent and satisfactory records pertaining to cash items and overdrafts;
  - Teller cash sheets that do not contain adequate details;
  - Investment subsidiary ledger that fails to list all necessary information;
  - Bank account reconcilements that are not current or fail to reflect the description and disposition of outstanding items;
  - Inadequate details concerning debits and credits to the cash account;
  - Correcting record keeping errors by erasing instead of crossing through the error;
  - Numerous corrections each month;
  - Failure to make daily postings to the accounts and records;
  - Failure to promptly close the books each month; and
  - Failure to review exception and other internal control reports.

7. **Audit Program** – Every credit union should have an adequate audit program. An active supervisory committee may be adequate for small, limited service credit unions, while medium-sized institutions offering more than basic services should employ the expertise of an external auditor to perform the annual audit. The supervisory committee can perform the account verification and internal audit functions. Ideally, larger credit unions should consider a program that consists of a full-time internal auditor reporting to the supervisory committee and an annual external audit performed by an independent third party accounting firm.

The scope of the internal audit depends on the size of the credit union and the number and complexity of the services offered. Because of cost constraints, many credit unions can not afford a full-time internal auditor. In this case, periodically the supervisory committee can perform: bank reconciliements, cash counts, review of employee and official's loans, review of activity within accounts designated as dormant, and review of expenses and the supporting documentation.

**Administrative Controls** – Administrative control is a managerial responsibility that directly affects the success or failure of the credit union. These controls establish lines of authority and responsibility, segregate the operating and recording functions, and provide for the hiring of qualified employees.

Although the uniqueness of each credit union defies one set of internal controls for all, an effective plan for administrative control should contain the following at a minimum:

1. **Accounting System** – The board should adopt an accounting system that is flexible in its capacity and rigid in its controls and standards. The system should provide timely, accurate, and useful data to all employees. All staff should be adequately trained on the system prior to performing transactions that affect general ledger and member accounts.
2. **Written Policy and Procedure** – Credit union policy is established by the board to direct operations and establish clear limits and authority. Operational staff develops procedures, they are normally not approved by the board. Procedures describe “how” to do a job. Regardless of the credit union’s size, written policies and procedures are imperative. Policies and procedures let all employees know what is expected of them, how they should perform their job duties, and what the consequences are if they do not perform them as required. Written policies and procedures also enable the credit union and its employees to treat each client consistently. These policies and procedures should be included in a regularly updated operations manual. The manual should clearly define the steps required for each transaction, explain how to handle exceptions, and delineate lines of authority. Employees should be required to review all policies that pertain to their position during initial job training and annually thereafter.
3. **Board Approval and Monitoring of Information** – In addition to policy, the board establishes control and direction through the annual budget and the longer-term

business plan that they are a part of developing, approving, and reviewing on a periodic basis. The board should request, at least monthly, the following reports to monitor the financial condition of the credit union:

- Balance Sheet;
  - Income Statement;
  - Cash Flow and Liquidity Analysis;
  - Comparison of Actual Results to Budgeted Figures;
  - Outstanding Investments;
  - Delinquent Loans; and
  - Savings and Lines of Credit Overdrafts.
4. Cash Control – Cash is the most liquid and accessible asset to most employees. As such, controls to prevent the conversion of this asset by officials or employees for their own personal use should be established. Adequate cash controls include:
- Surprise cash counts that are performed routinely;
  - Cashiers that are required to balance the contents of their cash drawer with the general ledger total daily, additionally, cashiers should not be allowed to leave the credit union until the drawer balances or the difference has been recorded as income or expense;
  - Cash limits established for the total amount that can be kept on the credit union premise, in the vault, and in each cashier's drawer;
  - Limited access to the vault and cashier drawers to those individually responsible for the funds in the vault or drawer;
  - Immediate verification under dual control of cash upon receipt;
  - Counting of cash under dual control if tellers buy or sell funds to the vault or another teller;
  - Documentation of all transactions made by and between cashiers with a receipt;
  - Vault and cashier drawers equipped with adequate, functioning, locking devices; and
  - Prohibiting cashiers and employees to transact business on their own accounts or those of related persons.
5. Segregation of Duties – The participation of two or more persons in a transaction creates a system of checks and balances and reduces the opportunity for fraud considerably. The credit union should assign duties so no one person dominates any transaction from beginning to end. For example – A person handling cash should not post to the accounting records; a loan officer should not disburse loan proceeds for loans they approved; and those having authority to sign checks should not reconcile bank accounts. In situations where this separation of duties is not possible, because of a limited staff, the supervisory committee should perform additional procedures to offset the lack of adequate control.
6. Dual Control – Accessing vaults, files, or other storage devices should require at least two keys or combinations under the control of at least two different people. Effective dual control mandates that all employees carefully guard their key or combination;

thus, only collusion can bypass this important control feature. Examples of items that should be under dual control are: vault cash, negotiable collateral, investment securities, reserve supply of checks, unissued travelers' checks, credit cards and money orders, the night depository, mail receipts, ATM cash, dormant savings accounts, and spare keys to cashier drawers.

7. Protection of Assets – A principal method of safeguarding assets is to limit access to authorized personnel only. Protection of assets can be accomplished by:
  - Developing operating policies and procedures for cash control;
  - Establishing dual control over cash;
  - Conducting periodic physical inventories of credit union assets;
  - Protecting assets by purchasing adequate insurance;
  - Requiring the use of passwords to access the computer system and changing passwords no less than quarterly; and
  - Limiting physical access to cash and the computer system.
8. Zero Tolerance – The credit union should have a culture that supports internal controls and does not tolerate excessive errors or fraud. These values can be promoted by establishing:
  - Severe consequences for fraud that are written, conveyed verbally, and strictly followed. All fraudulent acts should be met with swift and permanent action;
  - Clear negative consequences for staff with excessive error rates;
  - A performance based incentive system that rewards high productivity and low error rates;
  - Competitive salaries that reduce the motivation to commit fraud; and
  - Training that explains the reasons behind internal controls and emphasizes how fraud and errors hurt the institution and its members.
9. Personnel Policies – Personnel policies should specifically state the consequences for fraudulent acts and excessive errors so each employee understands the ramifications of such actions. Employees should be familiar with the personnel policy; a review of this policy should be part of each employee's initial training. The policy at a minimum should:
  - Require management to check references of prospective employees;
  - Include written position descriptions that define the duties, responsibilities, and performance standards for each position; and
  - Require written performance appraisals of all employees annually.
10. Rotation of Personnel – From time to time, employee job functions should be rotated unannounced. The rotation should be of sufficient duration to discover any fraud. Besides being an effective internal check, rotation of personnel is a valuable aid in the credit union's overall training program as employees learn how to perform other jobs. The cross-trained employee can substitute when other employees take vacations, are absent, or are rotated.

11. Succession Planning – The on-going success of credit unions will be greatly impacted by the ability to fill key management positions in the event of resignation or retirement. Succession planning should address the general manager and other senior management positions. The existence of a detailed succession plan that provides trained management personnel to step in at a moment's notice is essential to the long-term stability of a credit union.
12. Mandatory Vacations – Credit unions should have a vacation policy that requires all employees to take at least 5 consecutive working days off. During this time they should have no access to credit union records. An uninterrupted work schedule frequently is needed to embezzle funds unnoticed.
13. Quality Control – The board of directors should establish a review process, also known as internal auditing, to determine that management and staff comply with credit union policies and procedures.

**Signs of Warning** – The following are possible indicators that internal controls are not adequate to discourage dishonest or fraudulent acts. Credit union officials or management should take corrective action to reduce the chance of fraud. Regulatory authorities should address these shortfalls with the officials and management and develop plans to enhance internal controls.

- Little or no internal controls in place;
- Inadequate segregation of duties with limited internal controls in place;
- Inactive supervisory committee;
- Unacceptable or lack of external audit or member account verification;
- Numerous record keeping problems;
- Accounting records and financial statements in arrears;
- Management reports and accounting records destroyed or missing;
- Employees or officials with financial problems;
- Multiple family members or related parties control operations;
- Inadequate or no review of internal control reports provided by the computer system;
- Computer entries do not identify the employee that performed the transaction;
- Employees share their password with other individuals;
- The computer system lacks adequate controls and audit trail and it is easily manipulated;
- High employee turnover; and
- Poorly trained staff.

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