Examination Process – Investment and Cash Analysis
October 26, 2002

Credit unions continue to improve their mobilization of member savings and, in some cases, the demand by members for loans does not keep pace with the savings growth. Under this scenario the investment portfolio increases and represents a substantial percentage of the assets. This makes management's ability to wisely invest its excess funds increasingly important.

Objective of Investment Analysis – The objective of the investment analysis during an examination is to determine:

- The adequacy of investment policies, procedures, and internal controls;
- The legality of investments, as well as compliance with related regulations, accounting procedures, and other guidelines;
- The suitability of the investment and management's understanding of the investment;
- The fair value of the investment portfolio and the effect of a potential loss on the credit union's earnings and financial position; and
- That management quickly corrects investment related problems.

Scope of Investment Analysis – The extent of the examiner's review of investments will depend on:

- The quality and comprehensiveness of investment policies, procedures, and internal controls;
- The presence of illegal or inappropriate investments taking into consideration the sophistication of the credit union and management's understanding of the current investment portfolio;
- The condition of investment records;
- The volume and materiality of investment transactions; and
- The degree of problems disclosed by previous external and internal audits and/or examinations.

Examiners may reduce the physical review of investments if the credit union has not changed its investment policy since the last examination, the previous examiner or auditor noted no investment internal control weaknesses, and the credit union has not changed the investment mix substantially. If the credit union has never been examined by the regulatory agency, all outstanding investments should be reviewed.

Investment Policy Review – The board of directors of each credit union must have a written investment policy that complies with the Law, rules and regulations and other applicable laws. The Board should review and update the policy no less than annually. Each credit union should also have a monitoring and reporting program to ensure that the investment process adheres to the written policies.

Examiners should start the investment review by reading the written investment policy and procedures. Examiners should ensure that the investment policy, at a minimum, addresses the following:

- **Objectives –** Objectives balance the need for safety and liquidity against the need for yield while remaining flexible enough to respond to rapid changes in interest rates. Thus, the investment objectives should closely coordinate with internal asset-liability goals and long-range plans. In addition, officials should state the intentions regarding the securities purchased, and state whether they purchased the securities to hold to maturity, sell, or trade.
- **Permissible investments and legality -** The policy should state the types of investments that credit union management is allowed to invest in. Examiners should ensure that these investments are legal, that management has a good knowledge of the investments, and that the investment is appropriate for the size and sophistication of the credit union.
- **Diversification -** The board should also establish the maximum amount that may be in any one type of investment and the maximum maturity or term for investments. These policy elements assist in diversifying the investment portfolio and reducing the risk of concentrating funds in one type of investment.
- **Liquidity –** The board must give consideration to future liquidity needs, asset-liability management strategy, capital adequacy, and management of interest rate risk when drafting the investment policy. The policy should be flexible enough to allow for changes in the balance sheet's largest accounts – member savings and loans. Examiners should ensure that the policy addresses the liquidity needs of the credit union and that the policy is reflective of the operational environment and cyclical cash in and out flows.
- **Accountability –** The board of directors may delegate its authority for authorizing the investment of credit union funds to the manager, investment committee or third party. The examiner should ensure that the board:
    1. Investigates the integrity and financial condition of a third party prior to delegation of authority;
    2. Reduces the delegation of authority to writing and explicitly states the level of authority delegated;
    3. Understands that they are ultimately responsible for all investment decisions, the Board cannot abdicate their fiduciary responsibility to maintain a safe and sound portfolio; and
    4. Receives an investment report and reviews the investment decisions made, no less than monthly.
- **Internal Controls –** The policy should require adequate internal controls and the examiner should ensure that they are in place. Internal controls should separate the responsibilities of approving, disbursing, reconciling and accounting for investment activities.
- **Safekeeping –** The board should establish investment policies, which will protect securities held in safekeeping by a third party**.** A third party (bank or other financial institution) should hold all securities not in the physical possession of the credit union in a safekeeping account. Safekeeping agreements should provide that all transactions will be initiated only by an authorized employee or official of the credit

union and that funds will not be transferred until the securities are received by the credit union.

- **Reporting Requirements –** Examiners should verify that the policy requires management to report to the board monthly as to changes in the investment portfolio and ensure that management provides the Board a detailed monthly investment report. At a minimum, the report should include:
  - The name of the investment;
  - The current balance as of the report date;
  - The market value compared to the amount on the credit union's general ledger;
  - The interest rate, whether it is fixed or variable, and yield;
  - The investment maturity;
  - Who made the investment;
  - An indication of any new investments made since the last report;
  - A summary of investments by type so that officials can determine that the portfolio is properly diversified; and
  - Any comments or observations regarding the investment portfolio.

Physical Review of Investments – Examiners should use a workpaper, or similar form such as the monthly board report that includes all of the investments and correct balances as of the examination date. At a minimum, the examiner should include the following information in writing:

- Name of investment;
- Date investment was made;
- Amount of initial investment;
- Current investment balance;
- Interest rate;
- Current market value of investment;
- Who made the investment;
- Type of investment; and
- Examiner comments.

For all subsequent examinations, the prior exam workpaper should be reviewed noting any changes to existing investments such as market value. Investments made since the last examination should be noted on the existing workpaper, if information can easily be added or noted on a new workpaper.

When reviewing the investment documentation, the examiner should review the originals of all investment transactions and should ensure that: all investments are in the credit union's name, all information provided on investment documentation is the same as that on the monthly investment report, the investments comply with all aspects of credit union policy, and the individual making the investment was authorized to do so. Examiners should observe that all investments are stored in a safe, secure, fireproof location. Any differences that can not be reconciled must be included on the Examiner Finding document or, if material, in the Document of Resolution.

Examiners may review 100% of the investments in the portfolio or sample the investments in the portfolio if the credit union is large. For example – if the credit union has 100 certificates of deposit, the examiner may review a sample of ten deposits. If problems exist, examiners must then expand their analysis to determine the severity of the problem and develop corrective measures.

Investment Subsidiary Ledger Records - While all credit unions must maintain adequate investment records, the sophistication of these records will depend on the level of activity and the types of investments involved. Credit unions with a substantial portion of their assets in investments, or that have substantial investment activity, should maintain adequate individual subsidiary ledgers for each investment. The subsidiary ledger, a record of all transactions involving that security should record the following information:

- Name, type, and identification of investment;
- Par value and any premium/discounts;
- Date of issue;
- Date of maturity and if there is a call date(s);
- Date of purchase and sale;
- Current book value;
- Interest rate;
- Timing of any interest rate adjustments;
- Interest rate caps and floors;
- Interest payment dates;
- Current fair value (as of each month end); and
- Location of Document.

Examiners should ensure that total investments noted on the subsidiary ledger are equal to the general ledger amount, the subsidiary ledgers are current and that they provide officials with sufficient information to manage their investment needs.

Investment Valuation – If the credit union does not plan or can not hold an investment to maturity, then examiners should ensure that a reserve for investment losses has been established as to fully and fairly disclose the true asset size. Examiners should also compare the potential loss to the credit union's institutional capital to determine the impact the loss would have on the financial condition.

In determining the fair value of the credit union's investment portfolio, examiners may use data supplied by the credit union as of the examination's effective date, if available. If examiners doubt the data's accuracy, they should test the data to determine the accuracy of the stated fair value. This may include reviewing the business section of a newspaper for quotes or investment prices or contacting a knowledgeable third party. Material miscalculations or inaccurate disclosures of the fair value of the investment portfolio are signs of weak internal controls and requires immediate corrective action.

Foreign Currency Investments – If a credit union has investments dominated in foreign currencies, the investment policy should state the specifically approved currencies for holding foreign investments and the authorized third parties for executing these transactions.

During an examination, the examiner should determine:

1. The nature of all foreign currency investments;
2. The currency in which the investment is made is authorized under the credit union's investment policy;
3. The amount invested in foreign currency as compared to total investments;
4. The expected gross yield on the investment;
5. All of the data described above under the heading "Investment Subsidiary Ledger Records" is documented for each individual investment;
6. Foreign exchange risk is controlled through asset-liability management by funding a similar amount of liabilities in the same currency;
7. That in converting the investment to the local currency for accounting purposes, the credit union recognizes the appropriate gain or loss on conversion in accordance with International Accepted Accounting Principles.

Signs of Warning – These signs or indicators are ratios, numbers, trends, or suspicious activity that may indicate existing or potential problems. During the review of the investments, the examiner should look for the following signs of warning:

- Purchase of investments that do not meet board guidelines with respects to risk, quality, or quantity;
- Significant changes in the type, quality, or maturity distribution of the portfolio; and
- Investment returns that are well above or below the market.

Investment Deficiencies – Problems that can not be resolved during the exam, and are not material, should be noted in the final report in the "Examiner Findings". This document lists operating exceptions, violations of law or regulation, unsafe and unsound policies, practices and procedures. Relatively minor or infrequent infractions should not be discussed within this document; they distract from the more important matters. Immaterial issues should be discussed orally with the manager or appropriate employee.

When identifying a finding, the examiner should include a precise description of the problem or violation, who is responsible for correcting the problem, the specific section of the Law, bylaws, rules and regulations or other authority which the finding violates. In the event that the credit union violates more than one of the aforementioned, the examiner should cite the highest authority. Examiners should also include on this document exceptions that were noted at previous exams that have yet to be corrected. These findings should be cited under a heading of a similar nature. Issues and problems of a material nature should be addressed in the Document of Resolution.

Objectives of Cash Analysis – The objectives of reviewing cash and cash-like items are to determine that the officials and management have the following:

- Adequate policies, practices, procedures and internal controls for all phases of cash operations;
- Established guidelines within which officials and employees operate;

- Procedures for prompt corrective action when deficiencies are noted; and
- Adequate security measures for replenishment, deposit activities, and transportation of cash-like items.

Scope of Cash Analysis – The scope of the cash analysis will depend on the following:

- The quality of policies, procedures, and internal controls;
- The condition of the cash records;
- The degree and materiality of cash transactions;
- The complexity of operations; and
- The degree of problems disclosed by previous internal and/or external audits or examinations.

Examiners should design, and expand as necessary, the scope of the cash analysis to uncover major weaknesses in a credit union's cash operation. The scope should also incorporate a review of management's corrective actions taken to address weaknesses noted at prior examinations and annual audits. If examiners find weaknesses, they should expand their analysis to satisfy their concerns.

Cash and Cash-like Items – The following are cash and cash-like accounts established by the board of directors for specific purposes. The board should authorize the maximum amount for each account type:

- **Petty Cash –** Used for making incidental or small payments (purchase of a few postage stamps, coffee for the office, birthday cake for an employee, etc.).
- **Cashier Change Fund –** Established and used for processing member transactions; may vary in amount based on temporary, seasonal, and projected demands.
- **Vault Change Fund –** Replenishes the cashier's change fund; may vary in amount based on temporary, seasonal, and projected demands.
- **Bank Cash –** These accounts generally replenish the vault change fund, cover loan disbursements, and make expense payments, payroll, and large savings withdrawals that can not be met by the cashier change fund. Included in bank cash are transaction-type accounts such as checking accounts and liquid savings accounts at other financial institutions. Note – The examination procedures for bank cash are addressed under the Examination Process- General Ledger Review.

Petty Cash Review – Although the amount of the petty cash fund is generally immaterial, in cases where examiners note problems they may want to review the fund to determine that:

- The balance of the fund does not exceed the authorized amount;
- Management has physically segregated it from other cash funds and provides accountability by limiting access;
- Valid receipts (initialed by the employee making the purchase) evidence payments made from petty cash, and the sum of the funds and receipts total the authorized amount;
- Management replenishes the fund in a timely manner and records the expenses monthly;

- The Board approves any changes in the fund's balance; and
- The internal and external auditors periodically verify the fund's balance.

If examiners review internal controls and activity in the petty cash, they should design a workpaper that notes the date of the review, who performed the review, if a physical count was performed, if the amount in the fund was equal to the general ledger balance and any examiner findings or observations. Any weaknesses involving petty cash should be brought to the attention of the officials and management during the course of the exam and documented on the Examiner Findings document.

Cashier Change Fund Review – The teller change fund may represent a large percentage of cash depending on transaction volume and temporary, seasonal, and projected demands. The examiner's review of the change fund should include the following, at a minimum:

- Review of the summary for all cashier's change funds – The summary total of all the cashier's should be equal to the general ledger total for cashier change fund as of the effective date of the exam and each cashier's individual total should be a component of the total summary.
- Review at least one month of system-generated cashier activity reports that reflect the system's beginning and ending cash balances, and all cash and check transactions – The cashier end of day activity reports should balance with the next day's beginning balance for each cashier. If they do not balance, the manager and employee should initial the report and it should be noted on the report why it does not balance and in what general ledger account the difference was accounted for.
- Verification of a sample of individual cashier change funds – Examiners may verify the amount of the cashier change funds by performing a physical count. This should be performed on a surprise basis, on a day other than month-end, and all documentation included in the exam workpapers. Examiners should also review surprise cash counts by the internal and external auditors to ensure they are being executed correctly, conducted on a surprise basis, and performed periodically throughout the year on all the cashier's change funds.

In addition to the verification procedures, examiners should determine the following during the review of cashier change funds:

- The amount in the cashier change funds does not exceed the maximum established by the Board, the amount established by the Board is reasonable, and the individual teller change funds do not exceed the amounts established by management.
- Cashiers sell their excess cash (above the established maximums) to the vault.
- Management has procedures in place to immediately remove terminating cashiers' access to cash operations and to audit and restrict access to vacationing cashier's change funds.
- Cashiers are restricted by policy and computer authority from processing transactions on their own accounts and accounts of family members and relatives.
- Management restricts cashiers' computer authority, in terms of access levels, and has controls in place to identify cashier transactions by teller codes or identification numbers.

- Management instructs employees to keep confidential their cashier log-on password and requires that passwords are changed periodically.
- Cashiers lock their drawers when they are away from their work area and secure their locked drawer in the vault overnight.
- Management restricts a cashier's access to an individually assigned drawer and uses dual controls to prevent unauthorized access to teller drawers.
- All checks or negotiable items received are cleared from a cashier's drawer daily and cashiers are prohibited from holding checks, IOUs, etc. as part of their change fund balance.
- Debit/credit memos signed by both parties evidence cash purchases between the vault and cashier drawers or between cashiers.
- Cashiers are required to balance their drawer's daily, with respect to the physical amount in the drawer as compared to the computer's end of day balance.
- All members receive transaction receipts for all business performed with the cashiers.
- Management maintains a clear audit trail by promptly and accurately recording to the general ledger all cash activity, including teller differences.
- The "bait money" is properly segregated so that cashier's do not use the funds except in the case of a robbery.
- Management maintains dual control access to night depository funds and mail, and requires the presence of both persons when removing, processing and documenting the contents.

Internal control weaknesses, cashier errors, and breaches of cash policy are generally reported as Examiner Findings. All of the findings noted should be discussed with management prior to noting them on the Examiner Findings document. If the error or problem is material (would cause a negative impact on the credit union's financial position) then it should be included in the Document of Resolution.

Vault Change Fund Review - The vault change fund generally represents the largest part of the cash amount on the credit union's premises. Because of the volume and fluctuation, the vault should be balanced daily; a physical count should be performed by the vault cashier and compared to the computer total. Examiners should review vault activity by:

- Reviewing the end of day vault change fund counts signed by the vault cashier and manager to determine they were performed daily under dual control, and
- Reviewing the vault change fund general ledger detail to ensure that the end of day counts balance with the general ledger balance and that there is no unusual activity.

Examiners normally do not perform vault counts, only when fraudulent or suspicious activities exist. The vault is normally counted by the internal and/or external auditor on a surprise basis.

In addition to the verification procedures, examiners should determine the following in their review of the vault:

- The amount maintained in the vault is reasonable for the credit union's operations;
- Management adheres to the maximum vault limit established by the Board;

- The internal and/or external auditors are performing periodic surprise vault counts;
- Management limits vault access to the vault teller only and physical access to the vault to combination and/or key;
- That the vault remains locked during and after business hours;
- Management requires dual control for opening and counting vault change fund replenishments and a signed bank receipt as evidence the cash shipment was shipped and received by a credit union employee;
- A clear audit trail is maintained by accurately recording to the general ledger all vault change fund activity and differences in the vault are either resolved timely or recorded to an expense account;
- Two part debit/credit memos signed by both parties evidence cash purchases from and cash sales to the vault;
- Policies exist that do not allow a cashier that is responsible for a drawer and the vault to co-mingle the finds; and
- That vault policies, procedures, controls, and balancing procedures provide for adequate safeguards and accountability over vault cash operations.

Any errors or problems during the review of the vault should be discussed with management and documented in the Examiner Findings. If the problem is material in nature then it should be addressed in the Document of Resolution.

Signs of Warning - These signs or indicators are ratios, numbers, trends, or suspicious activity that may indicate existing or potential problems. During the review of cash, the examiner should look for the following signs of warning:

- Cashiers that have access to other cashier's drawers;
- Cashier drawers and the vault are left open and unlocked;
- Amounts in the cashier drawers and vault are in excess of the established maximums;
- Debit/credit memos are incomplete or completed incorrectly;
- Cashier drawers are out of balance, a difference exists between the physical count and the computer system total;
- Lack of adequate dual controls when counting cash received at the credit union or counting the cashier drawers, and/or vault;
- Cashiers that transact business on their own accounts, or that of family members and relatives;
- Cashiers who reveal their computer passwords to others
- Cashiers that do not sign off the computer when away from their work area;
- Cashier drawers that are not balanced daily;
- Numerous transaction errors;
- Cashiers that do not issue receipts for each transaction they process; and
- Lack of surprise cash counts by external and/or internal auditors.

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