Examination Process – Management Review

November 4, 2002

Evaluating the quality and effectiveness of management is a major examination step. This examination step is aimed more at the future than the current condition of the credit union and determines if current management is capable of responding to financial pressures and economic and local market changes. The assessment of management should not be solely dependent on the financial condition of the credit union. The quality of overall management should be evaluated by determining the effectiveness of the board of directors, the committees and operational management. The assessment of overall management should be based on reviews of the following four areas:

1. Internal Controls;
2. Management Conduct;
3. Service to Members; and
4. Business Strategy / Financial Performance.

The board approves policies that direct daily management and delegate the necessary authority to staff so they can fulfill all job responsibilities. Specifically, board and committee effectiveness can best be evaluated by reviewing board and committee minutes, the credit union's policies, the business plan and financial results.

Objective of the Management Review - Management is responsible for current operations and future planning. The objective of the review should determine that:

- Officials fully understand their duties and responsibilities and all important actions taken are documented in the minutes and policies;
- Officials are carrying out their responsibilities appropriately and are complying with laws and regulations;
- Officials have developed adequate goals and policies for all financial and operational areas;
- Conflicts of interest do not exist;
- Service to members, market penetration, and the rate structures are appropriate;
- Management is flexible, adapts to change, and keeps abreast of changes in the industry and the local market; and
- Management makes well-informed, sound decisions.

Scope of the Management Review – Depending on the size, complexity, and organizational structure of the credit union, examiners will discuss with the appropriate individual(s) or observe the following:

- Key personnel changes since the previous exam and future plans;
- Significant new programs or services and future plans;
- Significant acquisitions of new facilities and future plans;
- Computer conversions;
- Problems with the field of membership (e.g. - layoffs at a larger employer within the field of membership, strikes, etc.);
- Working relationship between the manager and the board of directors;

- Material changes in the investment portfolio and future plans;
- Material changes in the loan portfolio and future plans;
- Material changes in key policies, procedures, or future plans;
- Record keeping issues (e.g.- accounts out of balance, unreconciled accounts, etc.);
- Off-balance sheet risk areas, including lawsuits or contingent liabilities;
- Capital accumulation and maintenance strategy;
- Succession plan for key management positions;
- Systematic review of policies and procedures;
- Business plan (focusing on a 2-3 year future time frame) and the annual budget;
- Regular need for external credit; and
- Results of external and internal audit(s).

If no material changes have occurred since the last examination, examiners may use the following procedures in reviewing management:

- Scan the board meeting minutes for significant items and document in writing the review by recording material board actions only;
- Review the changes to policy and procedures made since the last examination;
- Review the credit union's annual budget, budget assumptions, and budget variance analysis;
- Review the business plan for the next 2-3 years;
- Review the committee minutes and activities only when problems are noted; and
- Review corrective actions taken to address problems identified at prior exams and audits.

All of the review steps should be documented in writing and included in the workpapers. The review should document: the area being reviewed, the scope or objective of the review, the examiner performing the review, the employee(s) who took part in the review, the results of the review, and any corrective actions needed.

Board Minute Review – The analysis of the minutes helps to draw conclusions about how officials and daily management interact and perform their job responsibilities. Much of this information can be useful in determining the adequacy of management and the effectiveness of their policies. The board minutes are vital records used to record board actions and information from board meetings. The following are considered significant actions and should be documented during the review:

- Loan policy changes;
- Agreements on collection problem loans and the approval of loan charge offs;
- Loans and savings/deposits rate changes;
- Record keeping problems;
- Discussion concerning new program proposals;
- Investment activities;
- Capital accumulation and maintenance strategies;
- Asset liability management and budget reviews;
- Financial statement reviews;
- Material fixed asset purchases;
- Loans to officials; and

- Progress towards meeting established goals and instituting corrective actions.

Minutes should be kept for all board and committee meetings along with minutes from the annual and reorganizational meetings. If meeting minutes are missing or incomplete, the examiner should discuss this with management and include it as an examiner finding.

Internal Control Review – Sound internal controls are a means of preventing fraud and quickly detecting errors. Without proper controls in place, management will not be able to identify and monitor operational risks. Internal controls should ensure that the credit union:

- Establishes and maintains accurate and reliable accounting and operational data;
- Properly safeguards its assets;
- Establishes adequate policies and adheres to them; and
- Enforces proper segregation of duties.

Examiners should review the following eight areas to assess the quality of the established internal controls.

1. **Information System –** It is crucial that the information system is secure and protected from unauthorized use to protect the integrity of credit union data. Examiners should ensure access is limited to those employees that work with the computer system and there is a permanent system record of employee ID access codes along with the transactions performed.

   Examiners should review all of the internal control reports generated by the system. These report names will vary by system. Examples of these reports include:
   - File Maintenance or Non-financial Transaction Report – identifies all changes made through the computer to member accounts;
   - Paid Ahead Loans Report – identifies loans for which the credit union advanced the due dates.
   - Supervisory Override Report – documents system overrides, based on established parameters, by personnel who have the authority to make the changes.
   - Negative Savings and Checking Accounts – identifies accounts with negative balances as of the report date.
   - Dormant Accounts – identifies accounts with no activity for more than one year (or selected time frame).

   There should be a written computer contingency plan available for review that specifically states the actions to be taken should a system failure occur. Examiners should ensure that the plan appears to be effective and that it has been tested.

   If the credit union has undergone a computer conversion since the last examination, this area of review should be expanded to ensure the credit union has adequate security measures in place and that the conversion did not adversely effect the internal control environment.

2. **Segregation of Duties –** The participation of two or more persons or departments in a transaction creates a system of checks and balances and considerably diminishes the possibility of fraud. Examiners should ensure that the credit union assigns duties so that no one person can perform a transaction from beginning to end. Examples include – a person handling cash should not post entries to general ledger accounts, a loan officer should not disburse loan funds, and those having authority to sign checks should not reconcile the bank accounts. In small credit unions with only one employee, this is more difficult to achieve. In this case, volunteers or officials should perform one or several of the steps in a transaction or the internal and/or external auditors should perform additional procedures to offset the lack of sufficient controls.

   Examiners should also determine that dual control is used wherever necessary. 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. Examples of items that should be under dual control include: vault cash, negotiable collateral, investment securities, safekeeping items, reserve supply of checks, unused traveler's checks, unused money orders, the night depository, mail receipts, dormant savings accounts, ATM cash, safe deposit box locks and keys, and spare teller drawer keys.

3. **Audit Program –** Every credit union should have an adequate audit program commensurate with its size. An active supervisory committee may be adequate for very small, limited service credit unions, while small to medium-size credit unions offering more than basic services should employ the expertise of an external auditor. 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 a third party.

   An effective audit function and process should be independent and report to the Supervisory Committee without conflict or interference from management. Each credit union should have an annual audit plan to ensure that all risk areas are reviewed and those of greatest risk receive priority.

   Examiners should review the annual audit plan, all reports, and any workpapers to gain additional understanding of the audit steps used. Examiners should ensure that both the internal and external audit programs are sufficient with scopes that are adequate to access the financial and operational soundness of the credit union. Upon the completion of an external and/or internal audit, a report should be issued to management and officials. Examiners should ensure that the reports are reviewed and corrective actions taken. Additionally, examiners should review the procedures of the annual member account verification. Member share and loan account balances should be verified annually and it should be performed without the participation of any operational employees.

4. **Accounting –** The accounting records of every credit union should be kept in accordance with established accounting principles. Examiners should ensure a credit union's records and accounts reflect its actual financial condition, are current, and provide an adequate audit trail. The audit trail should be clear and supported by sufficient documentation to follow a transaction from beginning to end. All general ledger account balances should balance to a subsidiary ledger that is independent of the general ledger.

5. **Protection of Physical Assets –** A principal method of safeguarding assets is to limit access to authorized personnel. Examiners should ensure that assets are adequately protected through operating policies and procedures that require dual control and that limit physical access where needed.

   Examiners should also determine that the credit union and its operations are adequately insured by reviewing all insurance documentation. The board should review the credit union's insurance coverage, at least annually, to determine it is adequate and document the review in the board minutes.

6. **Training of Personnel –** Examiners should determine that credit union staff is thoroughly trained with regards to their job duties and cross-trained in the job responsibilities of other staff positions as to enhance member service and internal controls.

7. **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 plans are usually only present in medium to large credit unions. Examiners should determine that a detailed succession plan exists. This plan should provide trained management personnel who are able to takeover quickly should the need arise so that the credit union's long-term stability is not adversely effected. A succession plan should address the manager or president and other senior management positions.

8. **Written Policies and Procedures –** The board of directors is responsible for the approval and revision of policies. Management usually develops the policies or at the very least makes suggestions as to what should be in the policies and presents the draft policies to the board for approval. Written policies should be present for: loans, investments, collections, asset liability management, personnel, capital accumulation, savings and deposits, and fixed asset purchases.

   Procedures describe "how" employees perform their job duties. Management and employees write the procedures and perform a review no less than annually. Procedures normally are not approved by the board. Examiners should ensure that adequate written policies and procedures are present, they are reflective of current operations and are followed by the employees. Without written policy, the employees can not provide consistent member service, as each employee will perform their job as they want, not as officials and management desire.

Management Conduct Review – The board of directors and management have a fiduciary responsibility to members to maintain high standards of professional conduct. Examiners must verify that management:

- Complies with the laws, rules and regulations, and established policies and procedures;
- Establishes appropriate compensation policies and practices for senior management. The board should have written performance standards for the manager and perform an annual written evaluation prior to salary increases, the manager should establish the performance standards for the employees and perform evaluations prior to their pay increases;
- Avoids conflicts of interest; and
- Uses professional ethics and behavior. Management should not use the credit union for personal gain and should treat each employee and member equally.

Business Strategy/ Financial Performance Review– A business plan that focuses on the next two to three years should be in place at every credit union. This plan should state the credit union's mission, it's goals and objectives, the action steps needed to meet the stated goals, and the projected financial results for the time period. The board should review, approve, and periodically revise the plan as unexpected changes warrant.

In assessing the adequacy of a business plan, the examiner should determine the following:

1. **Does the business plan have a strong foundation based on an assessment of the environment in which the credit union will operate over the medium term (next 2-3 years)?** Management should evaluate the external and internal factors influencing its business, including economic and regulatory issues, its member base, its competition, and its competitive opportunities. Credit union management should also consider different scenarios while planning such as changing interest rate environment, full employment, lay-offs, etc. The analysis should produce a set of assumptions that will be incorporated into the business plan.

2. **Is there a clear, written statement of key goals and objectives?** These goals and objectives should be realistic in regards to the credit union's analysis of the external and internal factors. The goals and objectives can be expressed in terms of income and expenses, projected balance sheet numbers, other performance indicators and/or products, services, or programs to be introduced.

3. **Are the mission and objectives incorporated with specific plans of action to attain the stated objectives and goals?** The plans of action should be accompanied by the individual(s) responsible for completing the action plan and the time frame for completion.

4. **Have projected financial statements (balance sheet and income statement) been developed for the business plan's time frame based on the mission, objectives,**

and established action plans? The projected financial statements are nothing more than a financial road map used to chart where the credit union is and where it wants to be. The projected financial statements and the underlying assumptions should be reviewed and compared to the actual results, no less than quarterly and revisions made when necessary so that the business plan is reflective of the current operating environment.

5. **Was the business plan and projected financial statements submitted to the board for their review and approval?** The review, suggested revisions, and the approval of the plan should be documented in the board minutes.

6. **Has the business plan been implemented satisfactorily?** The board is responsible for oversight of the business plan. Management is in charge of implementing the plan on the operational level. The mission, objectives, and action plans should be clearly communicated to staff at every level to ensure adherence to the business plan.

7. **Is the business plan monitored?** Periodically management and the officials should review the progress made towards achieving the stated goals and objectives and meeting the financial projections. Management should ensure that the credit union's policies and procedures and the credit union's resources (employees, capital, and equipment) are consistent with the plan and are capable of achieving the desired results.

   In addition to the business plan, management should develop an annual budget at the end of each business year for the upcoming year. The balance sheet numbers should be projected and the income statement numbers based on the balance sheet projections. All of the assumptions used to derive the numbers should be placed in writing. The board should approve the budget upon review. Periodically, the actual results should be compared to the budgeted figures and any variances discussed. Revisions should be made to the budget for any unexpected events or changes. Budgets and business plans are not mutually exclusive; each should be considered when developing the other.

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 management, the examiner should look for the following signs of warning:

- Supervisory committee that is not independent of the board and/or manager;
- Internal audit function that reports to the board instead of the supervisory committee;
- High or increasing employee turnover;
- Regular vacations not taken, employees work late hours;
- Nepotism;
- Abuse of official position or preferential treatment;
- Limited personnel; lack of segregation of duties;
- Lack of adequate segregation of duties when the credit union is sufficiently staffed;
- Failure to provide, or delays in providing, standard reports, records, and/or documents;

- Records not maintained at the credit union;
- Management or staff provide copies of documents rather than originals;
- Inactive supervisory committee;
- Lack of, unacceptable, or non-independent audit;
- Unacceptable member account verification;
- Inadequate internal controls and information system controls;
- No internal review of computer system generated internal control reports;
- Use of external credit for inappropriate uses, or in spite of large cash balances;
- Lack of a conflict of interest and fraud policies;
- Extravagant management or employee lifestyle relative to salary;
- Inadequate or lack of board approved policies;
- Lack of, or inappropriate corrective action taken with regards to problems and issues identified by examiners and external auditors; and
- Chronic, unresolved problems.

Management Deficiencies – Issues and problems of a material nature should be addressed in the Document of Resolution. The solution to the problem or the action that needs to be taken should be noted along with the individual responsible for taking the corrective action and the time frame in which the action or correction should occur. To enhance follow-up from one exam to the next, examiners should also include on this document action plans that were noted at previous exams that have yet to be corrected. These unresolved issues should be cited under a heading of a similar nature.

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, the individual 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.