Supervisory Committee Roles and Responsibilities

Presented by:

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So What Are We Talking About Today?

- Regulatory Requirements of Supervisory Committees
- Supervisory Committee Member Qualifications
- Your Responsibilities
  - Annual Audit
  - Internal Audits
  - Monitoring Internal Controls
- Administration of the Committee
- Internal Control Warning Signs and What You Should Do
- A Few Fraud Stories
- Resources available
Current Section 715.3 of NCUA’s rules and regulations states the Supervisory Committee is responsible to determine that:

- The financial condition of the credit union is accurately presented
- That management practices are sufficient to safeguard assets
- That accounting records are prepared promptly
- That internal controls are established and effectively maintained
- That plans, policies and control procedures established by the Board of Directors are properly administered
- Policies and control procedures to safeguard against error, carelessness, fraud and self-dealing have been established
The annual external audit, internal audit function and verification of member accounts are the activities generally used to carry out these responsibilities.
Supervisory Committee Qualifications

- Must be a member of the Credit Union
- No employee of the Credit Union may be a member of the supervisory committee
- Terms of all the members of the supervisory committee shall be for the same number of years - either 1, 2, or 3 year terms
- Experience in bookkeeping, accounting or auditing is helpful, but not required
- Possessing such qualities as inquisitiveness, professional skepticism, good communication skills, willingness to invest time are the primary attributes
As a practical matter, the role of the supervisory committee consists of the following responsibilities:

- Ensure that the annual audit requirement is fulfilled
- Ensure that the verification of member accounts is performed when required
- Monitor internal controls
- Monitor financial trends and reporting
The vast majority of credit unions hire an outside firm to conduct the audit.

Under current regulation, the annual audit requirement can be satisfied by one of the two following engagements:

- An opinion audit (can only be done by a CPA)
- A Supervisory Committee Guide Audit engagement (non-opinion engagement) that can be done by a CPA or any other person.
What is an opinion audit?

- Can only be done by a licensed CPA
- Results in CPA expressing an opinion on fairness of the credit union’s financial statements
- Places responsibility on the auditor to follow GAAS
- Highest level audit engagement possible, that demonstrates the credit union’s due diligence in conforming to the audit regulation
Supervisory Committee Responsibilities (CPA Audit)

- Relationship with the independent auditor
  - Selection of the CPA firm
  - Understanding the CPA firm’s quality control system
  - Making it clear who the CPA firm is working for
  - Communication with the CPA firm
    - At the audit planning stage, at the fieldwork completion stage, when the audit reports have been finalized
Non-Opinion Exam

What is a non-opinion exam?

- Work can be done by a CPA or anyone
- Engagement letter should be issued outlining the procedures to be completed
- Procedures must be sufficient to meet the minimum requirements of the NCUA
- There is no opinion expressed on the financial statements or conformity to GAAP
- A report is issued that describes procedures performed and observations and recommendations
- Less expensive than an opinion audit
- Most appropriate for smaller credit unions with clean and basic operations
Sample Verification

- If done by a licensed CPA, either a statistical or non-statistical sample may be done (as long as it is in accordance with Generally Accepted Auditing Standards)
- May be positive confirmations or a combination of positive and negative confirmations
- Statistical or random sample done by the Supervisory Committee requires minimum standards (table is in Chapter 24E of the NCUA Supervisory Committee Guide) and the use of positive letters is preferred
- Separate letter is sent to member (should have a controlled return address)
Questions the CPA firm should answer:

- What are the significant accounting policies?
- Did the credit union select the accounting policies that were most appropriate given the options?
- What about management’s judgments and estimates that play a role in the financial statements? How would you characterize them?
- Did you have to post any significant audit adjustments?
- Were there any waived adjustments?
- Did you have any disagreements with management?
More questions the CPA firm should answer:

- Did you encounter any difficulties in conducting the audit?
- Are there significant risks that management is not addressing?

Meet privately with the independent auditor in conjunction with the final audit report:

- Decide on how final report is presented to Board of Directors
Questions to ask the external audit firm:

- What did you perform for unpredictable procedures as part of your audit this year?
- If you had to mention one thing that could improve the effectiveness of the audit, what would it be?
- Are there any potential internal control problems that you discussed with management that didn’t end up in your written report?
- Did you issue a separate comments letter to management that was not provided to the supervisory committee?
- How many people in your firm’s credit union group?
- Did you rotate any staff on the audit job from the year before?
- How do you ensure a fresh look each year?
Consider the CPA firm as a resource should you need advice on red flags that arise during the course of the year

Review annually all relationships between the CPA firm and the credit union

Evaluate the auditor and audit process after the financial reports and management letter have been issued

Review the verification of member accounts performed by the CPA firm

Ascertain that the audit fee is appropriate
Supervisory Committee Responsibilities (Other Audits)

- Relationships with other professionals who perform audit-like functions
  - NCUA
  - State regulatory agency
  - Bonding company
  - IT Consultants
Supervisory Committee Responsibilities (Internal Audit)

- Relationship with the internal auditor
  - Internal, outsourced or co-sourced
  - Establish open line of communication
  - Determine sufficiency of independence
  - Review Risk Assessment—should tie to IA plan
  - Evaluate ability of internal auditor in relation to risk areas
  - Modify (if necessary) and accept annual internal audit plan
  - One, two or three year plans?
Supervisory Committee Responsibilities (Internal Audit)

- Relationship with the internal auditor
  - Evaluate the ongoing objectivity of the internal audit function
  - Meet at least quarterly and review the results of internal audits, including management’s response
  - Meet privately at least once a year with the head of internal audit
Credit Union’s System of Internal Controls

**Definition**: A credit union’s organization and system of procedures that provides a reasonable assurance that errors or irregularities will be prevented or detected on a timely basis.

**Provides reliance to**:
- Membership
- Management
- Auditors
- Examiners
Question: Who is responsible for the design and execution of the internal control system?

- A – The Board of Directors
- B – The Internal Auditor
- C – Management
- D – The Supervisory Committee
Credit Union's System of Internal Controls - continued

- The design and execution of the system of internal controls is the responsibility of management.

- Common examples of internal controls:
  - Segregation of duties
  - Cross training/rotation of duties
  - Completion and independent review of account reconciliations
  - Surprise cash counts of teller funds
  - Review of exception reports
Triangular Communication

Supervisory Committee/Internal Audit Validates

Board of Directors Guides

Management Owns Risk Sets Risk Agenda & Executes
Supervisory Committee
Responsibilities regarding Internal Controls

- Remember management is responsible for establishing, maintaining and monitoring

- Questions to ask management about internal control:
  - What is your assessment of the internal control system and what criteria did you base your assessment on?
  - Talk to us about the “Tone at the Top” and what you do to maintain an uncompromising ethical environment
  - Is there a fraud hotline, and how are employees informed about it?
Questions to ask management about internal control:

- Were any reported conflicts of interest or irregularities or other violations of the code of conduct identified during the year?
- Have the independent or internal auditors identified major control deficiencies?
- Can we get a tracking report of external and internal audit and regulatory findings and status of management’s response?
- Is there a specific management-level person designated as responsible for knowing and understanding relevant legal and regulatory requirements?
Keep up-to-date on changes in your credit union:

- New products and services being offered to membership
- Changes in field of membership
- Important issues being discussed by Board
- Mergers, key personnel changes, new investments,
- Technology changes.
- Ask external and internal auditors how they have addressed any resulting new risks from these changes in their audit plans.
Supervisory Committee Responsibilities regarding Internal Controls - continued

- **Keep up-to-date on changes in your industry:**
  - Risk Areas: See NCUA Letter to CU’s re risk area focus for 2014
    - Interest Rate Risk
    - Cybersecurity Threats
    - Money Service Businesses
    - Student Loans
Supervisory Committee
Responsibilities regarding
Internal Controls - continued

- Keep up-to-date on changes in your industry:
  - Regulatory and Accounting Changes
    - Lending Regulation Changes
    - Proposed Risk Based Capital Requirement Changes
    - Proposed Allowance for Loan Loss Changes
    - CUSO audit rule changes
Administration of the Supervisory Committee

- Create a charter
- Get the right people on the bus
  - Independent, objective & competent oversight is the goal
  - Financial literacy
  - Collective skills is what is most important
  - Use outside advisors when necessary
- Continuing education is essential
Administration of the Supervisory Committee - continued

- Get the right information at the right time
- Set meeting agendas
  - Cover Issues Tracking Reports
  - Look at agendas for past 18 months and evaluate their relevance
  - Include time to meet with auditors, and help auditors set the agenda for their meeting time
- Conduct regular meetings and record minutes
- Make annual report to the membership
Internal Control Warning Signs

The following are typical situations that may be internal control warning signs:

- Complex business arrangements that you can’t understand
- Last minute transactions that result in improvement in financial performance
- Change in estimates that are hard to understand
- Frequent differences between management and the auditors
- Management not receptive or responsive to auditor or regulatory findings
- Failure to enforce the credit union’s code of conduct
Internal Control Warning Signs - continued

- Failure by management to display and communicate an appropriate attitude regarding internal control
- High turnover of senior management
- Rapid changes in the industry
- Unusually rapid growth or profitability compared to other credit unions
Theft by Employees - the Profile

- Usually work alone
- Compulsive
- Work long and hard hours
- Rationalize their thefts
- Repeat the crime
- Access to cash or other liquid assets
- Intelligent
- Long-term employee
The Thief - Top Five Warning Signs

- Living beyond means: 43%
- Financial Difficulties: 36.4%
- Control issues: 22.7%
- Unusually close to customer or member: 19.2%
- Wheeler-dealer: 17.6%
Other Warning Signs

- Divorce/family problems
- Irritability or defensiveness
- Addiction problems
- Unwillingness to take vacations
- Past employment-related problems
- Complained about inadequate pay
- Excessive pressure from within organization
- Past legal problems
Shirley Inscoe, co-author of “Insidious: How Trusted Employees Steal Millions and Why it is so Hard for Banks to Stop Them”

The personality profile of a typical employee that commits this fraud is ironically the type of person banks want to hire...often committed by the popular senior vice president, the trusted branch manager, the customer service representative who never missed a day at work or the dependable administrative assistant. It’s a fact that fraudsters are often some of the institution’s top performers. That is because the same creativity, attention to detail, and intelligence that helps them succeed at their jobs also helps them succeed at fraud.
Addressing Red Flags

- Supervisory committee involvement
  - Inquiries of management
  - Inquire of auditors and internal audit about procedures that they have performed to identify and address weaknesses
  - Perform some actual procedures
- Gear more internal audit resources towards higher risk problem areas
Potential Weaknesses

- Changes to exception report review process needed: certain reports not produced, reviewed by the wrong person, no documentation, no written procedures
- Training schedules not formalized or documented
- Not all suspense and clearing accounts are reconciled and reviewed
- Fraud reporting process not clearly outlined
- Employees not aware of fraud hotlines
Potential Weaknesses - continued

- Loan collections
  - Payments collected by tellers not loan department
- Employee accounts and related accounts not reviewed
- No review of tellers who can do file maintenance
- Cash reconciliation with changing out of balance amounts
- Person performing reconciliation should be looking for unusual items—not just wanting to make it balance
More Weaknesses

- Investment account reconciliations prepared by same individual who authorizes or initiates transactions
- Same person can produce a check and can make journal entries
- Collections dept can make extensions with no review of extensions made
Even More Weaknesses

- Person reviews extensions, but they don’t have full population
- Person reviews loans, but they don’t select from full population
- Payroll duties concentrated in one individual, who receives and files the payroll journals
- Policies in place but not being followed
- Network administrator account shared by several employees
- No review of system access levels
Yet More Weaknesses

- Corporate credit card statements not reviewed
- Use of prepaid accounts to smooth expenses
- Accounting procedures not in writing
- No rotation of duties during vacation
- Review of “all” invoices before payment, but how do they know?
- Reconciler is the fox guarding the coop
Sup Com Procedures

- Ask if a review of employee access levels to the core system has been reviewed recently
- Review consecutive bank account reconciliations
- AIRES sorts
- Loan file review, missing loan files
- Ask for tracking report of auditor, regulator and internal auditor findings and status of how management has addressed
Sup Com Procedures - continued

- Inquire about suspense (clearing) accounts reconciliations
- Review expense items, trace to invoices
- Review a complete system-generated report of disbursements
- Obtain and review corporate credit card activity
- Ask for documentation of most recent balance sheet reconciliations-is a spreadsheet maintained?
- Review employee accounts
Sup Com Procedures - continued

- Obtain copy of the code of conduct, look at reporting mechanisms
- Ask for written copies of accounting policies and procedures
- Ask for written copies of loan and share procedures
- Inquire about management report review process-who is responsible for reviewing exception reports-how do they document their review?
It's Always Good to Get Clarification

Dilbert

Would you like to buy advertising in my new magazine called "Gullible World"?

We have between one and two billion readers!

I figured out how to make three readers sound like a lot.
Exception Reports to Review

- Dormants reactivated
- Closed accounts
- Address and rate changes
- Adjustments to accounts
- Multiple transactions to account in one day
- Employee account activity
- Advancement of due dates
- Security level changes
Exception Reports to Review

- Supervisor override reports
- Non-amortizing loans
- Negative share reports
- Loans by interest rate summary
- Paid ahead loan report
What About IT?

- Major risks are inability to serve members because of down systems, and data breaches
- What does external audit cover?
- What does internal audit cover?
- Risk Assessments
- IT General Controls Reviews and Testing
- Penetration Testing
- Social Engineering Tests
The 2012 Marquet Study

- Included the 528 specific cases of fraud that came to light in the United States in 2012 that involved employee theft of at least $100,000
- Fifth annual study—also includes aggregated five year conclusions
Aggregated 5-Year Conclusions for Major Embezzlements

- 2012 was a blockbuster year for employee theft
- Embezzlers begin scheme at average age of 43
- Average embezzlement spans a 4.7 year period
- By a significant margin, major embezzlers are most likely in bookkeeping or finance positions (68% of all cases)
- Financial services industry suffered the greatest losses due to major embezzlements
- 84% of cases involved people working alone
More 5-Year Study Conclusions

- Most common method was forgery or unauthorized use of company checks
- Most major embezzlers appear to have been motivated by desire to live a relatively more lavish lifestyle rather than financial woes
- Average prison sentence was just over 4 years for convicted major embezzlers
- Colorado and Massachusetts had the weakest sentencing track record for major embezzlers in 2012
Duration of Schemes

- Average duration: 56.2 months
- Median duration: 48 months
- Longest duration: 29 years
Methodology of Schemes

- Bogus Loan Schemes
- Credit Card/Account Abuse (use of company credit card or credit accounts)
- Forged/Unauthorized Checks
- Reimbursement Schemes (expense account fraud)
- Payroll Shenanigans
- Theft of cash receipts
- Vendor Fraud Scheme (bogus vendor or collusion with a real vendor)
## Methodology of 2012 Schemes

<table>
<thead>
<tr>
<th>Scheme</th>
<th>Number</th>
<th>% of Total</th>
<th>% of Total $</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unauthorized checks</td>
<td>151</td>
<td>28.6%</td>
<td>24.7%</td>
</tr>
<tr>
<td>Theft/conversion of cash receipts</td>
<td>118</td>
<td>22.4%</td>
<td>9.6%</td>
</tr>
<tr>
<td>Unauthorized electronic transfers</td>
<td>60</td>
<td>11.4%</td>
<td>41.6%</td>
</tr>
<tr>
<td>Payroll shenanigans</td>
<td>27</td>
<td>5.1%</td>
<td>7.9%</td>
</tr>
<tr>
<td>Credit card/account abuse</td>
<td>35</td>
<td>6.6%</td>
<td>1.8%</td>
</tr>
<tr>
<td>Vendor fraud scheme</td>
<td>44</td>
<td>8.3%</td>
<td>6.5%</td>
</tr>
<tr>
<td>Fraudulent reimbursement</td>
<td>21</td>
<td>4.0%</td>
<td>0.9%</td>
</tr>
<tr>
<td>Bogus Loan Scheme</td>
<td>21</td>
<td>4.0%</td>
<td>4.3%</td>
</tr>
</tbody>
</table>
### Age of the Perps

<table>
<thead>
<tr>
<th>Age Group:</th>
<th>20-29</th>
<th>30-39</th>
<th>40-49</th>
<th>50-59</th>
<th>60-69</th>
<th>70+</th>
</tr>
</thead>
<tbody>
<tr>
<td>% of Group</td>
<td>1.7%</td>
<td>20.4%</td>
<td>36.1%</td>
<td>30.7%</td>
<td>10.1%</td>
<td>1.1%</td>
</tr>
<tr>
<td>Average loss</td>
<td>$361K</td>
<td>$1,042K</td>
<td>$671K</td>
<td>$1,238K</td>
<td>$5,522K</td>
<td>$1,998K</td>
</tr>
</tbody>
</table>
How Frauds are Discovered

- Tip (50% employees)
- Management Review
- Internal Audit
- By Accident
- Account Reconciliation
- External Audit
BRUNSWICK, Maine-A 42-year-old Topsham woman was sentenced Monday to 33 months in federal prison for stealing more than $500,000 from Atlantic Regional Federal Credit Union, where she was employed for 23 years. In a sentencing memorandum, U.S. Attorney Thomas Delahanty II outlined Marsha Richard’s crime:

Over approximately six years, Richard “manipulate(d) accounting entries regarding checks that members had deposited but that had been returned for insufficient funds (‘return items’),” he wrote.

When funds were collected from a member’s account, rather than crediting the appropriate account, she credited her own account or the accounts of her daughter, husband or other family members or friends, and then diverted those funds for her own use.

Richard also “manipulated several different internal accounting systems” and fabricated reports and processed stolen funds through dozens of member accounts.

Richard was named Maine’s outstanding credit union employee of the year in 2009.
Credit Union Auditor Steals $150,000 over three-year period

- In an effort to support a gambling problem (and a girlfriend outside of his marriage), an internal auditor established several fictitious accounts by reversing fee income from various general ledger accounts.
Why the Reversal worked (for a while)

- The internal auditor had the ability to create new accounts and to reverse fees
- Nobody else was looking at fee reversals
- Fees sometimes hard to budget, so budget to actual didn’t sound an alarm
Clearance, Clarence!

- Theft of $1.3 million through the ATM GL Clearing accounts
  - Lack of adequate segregation of conflicting duties
  - Lack of secondary review
  - Lack of assigned responsibility
  - Lack of adequate control over GL reconcilement
  - Lack of proper follow up
  - Lack of identifying fraud indicators
HELENA, Montana-Ben Dively, 34, has been ordered to pay $88,818 in restitution and spend the next year in prison after being found guilty of embezzlement, money laundering, and identity theft in connection with his job as loan officer at Helena Community CU.

A five year employee, Dively stole the money by approving a line of credit from which he could make withdrawals. He circumvented the credit union’s security measures by using a co-worker’s PC and issuing the check to himself.
Philip J. Mongillo, 51, of Westbrook, Connecticut, pleaded guilty to one count of bank fraud in connection with his alleged embezzlement of more than $1 million from Dime Bank, where he had been employed as Assistant Vice President and Technology Officer. According to authorities, over a nine year period, from September 2001 until November 2010, Mongillo created and used a phony company to issue fraudulent invoices to the bank, totaling $1,029,050. Mongillo is due to be sentenced on September 2 and faces up to 30 years in prison, plus restitution.
In Like Flinn

- Tina Flinn convicted of stealing $350K from dormant accounts
  - DECATUR, Illinois-A former personal banker for Earthmover CU pleaded guilty to stealing more than $350,000 from the accounts of mostly elderly, sick and deceased members and gambling away the money. One credit union member saw Flinn losing a large amount of money at a video poker machine and reported it to the CU officials.

- Flinn stole the money from at least 20 dormant accounts. If anyone noticed that an account of a person who recently died was short, Flinn would admit the mistake, and correct it with money stolen from other accounts.
Flinn Case Control Weaknesses

- Weak controls over dormant accounts with respect to access and review procedures
- Weak controls with respect to monitoring activity on deceased accounts
- No monitoring of activity in employee accounts
References/Resources

- Federal Credit Union Act/ Bylaws, Rules and Regulations ([www.ncua.gov](http://www.ncua.gov))
- Supervisory Committee Guide ([www.ncua.gov](http://www.ncua.gov))
- ncua.gov also has many additional resources
- cuna.org
- cutimes.com
- creditunionmagazine.com
- Trade associations
  Association of Certified
  Fraud Examiners Report to the Nation on
  Occupational Fraud & Abuse
  [www.acfe.com](http://www.acfe.com)
  Marquet Report on Embezzlement
  [www.marquetinternational.com](http://www.marquetinternational.com)
Serving Credit Unions Throughout the Northeast

- Financial “CPA” Audits
- Internal Audit Outsourcing and Co-Sourcing
- Compliance Audits
- Risk Assessments
- Fraud Audits
- Supervisory Committee Audits
- Merger Advisory
- Information Technology Assurance
- Strategic Planning