



Dialogue

on Sound Business & Financial Practices

Dialogue is produced in association with an industry advisory committee to promote discussion between directors and management on featured topics.

Readers' questions are welcome, and may be featured in a future **Dialogue**.

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FUTURE TOPICS:

- OSV - FAQ's
- Board Planning Tools
- Business Planning
- Privacy Considerations
- By-law #5 Review

INTERNAL AUDIT

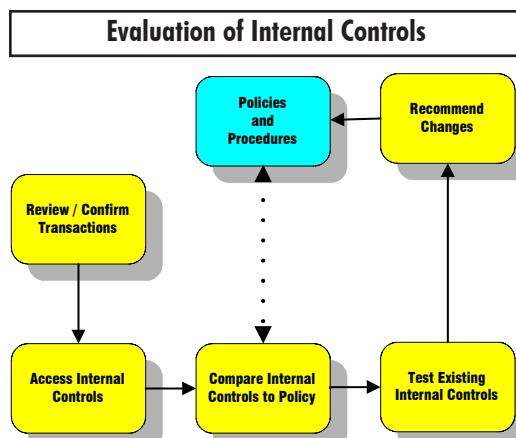
In response to several inquiries, the following article has been developed to provide additional information and guidance on internal controls and the role of internal audit.

The main objective of the internal audit function is to evaluate the internal control environment and make recommendations to the Audit Committee of the board and management as appropriate to correct weaknesses and prevent frauds. Unfortunately, over the years credit unions have been victims of internal frauds. In most cases, these frauds were perpetrated because internal controls were either not in place or were not being followed.

Internal Audit reports help determine whether or not:

- Board policies and directives have been appropriately implemented;
- Accounting records are reliable and adequately maintained;
- Assets are safeguarded from theft, fraud or physical deterioration.

Internal audits are usually performed by designated independent staff who report findings directly to the Audit Committee. In some cases, it may be more practical or cost effective to have internal audits performed by third party contractors. Alternatively, particularly at less complex institutions, the Audit Committee may elect to conduct internal audits. The following flowchart provides an overview of the major elements of evaluating internal controls.



When evaluating internal controls, the following steps should be considered:

1. Review:

Confirm the flow of transactions for each major process or function either by flow chart or narrative.

For example, for loans, this might include the application process, loan evaluation, loan approval, security valuation and registration, and loan disbursement.

2. Assess:

Consider possible weaknesses and identify internal control procedures that are in place to prevent material deficiencies.

For example, for loan approvals, a weakness may be identified where loans are disbursed by the same individual that approves loans. Internal control procedures might be in place to help mitigate this weakness whereby a post review of all new loans is to be undertaken by an independent Credit Committee or the Audit Committee.

3. Compare:

Compare internal controls that are in place to those authorized in policy and outlined in procedures. Summarize what internal controls are missing.

For example, internal controls may not provide adequate safeguards for dormant member accounts. Policy or procedures will likely require dual custody of records and joint approval for re-activation of the account and/or disbursement of funds with appropriate verification of member identification.

4. Test:

Test existing internal controls. This will involve a review of sample transactions to determine compliance to policy and procedures.

When testing internal controls for accounting records, evidence of the following should be considered:

General Ledger

- Subsidiary records (e.g. loan trial balances) have been regularly compared and reconciled to the General Ledger accounts;
- Records are independently verified;
- Any differences are documented and approved as necessary;
- Suspense accounts are reconciled daily and outstanding items regularly verified by an independent party to ensure transactions are valid and appropriate.

Bank accounts

- Bank accounts are reconciled and independently reviewed;
- Appropriate rationale is provided for outstanding items and differences;
- Outstanding items are appropriately documented and investigated.

5. Recommend:

Changes to policy and internal control procedures should be recommended as appropriate.

For example, policies may not adequately identify the appropriate internal controls for each function or address potential weaknesses due to limited resources that may be available. Also, internal control procedures may not be followed in all cases or transactions reviewed and verified by independent parties to help minimize potential exposure and possible losses.

SEGREGATION OF DUTIES

Segregation of duties helps minimize the likelihood of losses, avoids and detects errors, and maintains the integrity of records and financial data. An organization chart and/or job descriptions for each function are helpful to ensure job functions are appropriately segregated. The following are considerations for segregating job functions:

- the same individual should not be responsible for all the major steps in a single transaction (e.g. initiation, authorization and record keeping). This is particularly important for loans (i.e. loan application, loan approval, loan disbursement) and bank accounts (i.e. signing authority, reconciliation, investigation of outstanding items);
- joint custody should be established for combinations, keys, cash and negotiable instruments.

FOR "LESS COMPLEX" MEMBER INSTITUTIONS

Where the number of employees does not allow for adequate segregation of duties, the following alternative practices should be considered to help minimize potential risk:

- Employees who authorize transactions may be permitted to record the transaction, although these individuals should be restricted from the unilateral receipt and disbursement of funds;
- Cheques or other large transactions should require the signature of the manager and a board member (usually the Chair);
- Members of the Audit Committee should review transactions processed by the manager, especially those of a high dollar amount or those of an unusual or recurring nature;
- Accounting and banking records should be audited independently on a timely basis, including confirming the authenticity of all large or unusual transactions and outstanding items.

AUDIT COMMITTEE AND BOARD ACTIVITIES

The Audit Committee and the board should review the information that it receives regarding internal controls.

This information comes from a variety of sources, including:

- Internal control audit reports;
- The external auditor's report, including the "Section 172" management letter;
- On-Site Verification (OSV) reports from DICO;
- Issues brought forward by members.

Any weaknesses should be evaluated and appropriate resolution strategies developed to resolve material weaknesses as soon as possible. By implementing appropriate internal controls and establishing an operating environment of accuracy and integrity, the likelihood of error and fraud is significantly minimized.

REFERENCE SOURCES

DICO By-law # 5: Standards of Sound Business and Financial Practices; Sound Business and Financial Practices Reference Manual: Chapter 9; Guide to DICO's On-Site Verification (OSV) Process; DICO's OSV Manual.

Sample questions for the board and management:

- *Do we have sufficient resources to provide for appropriate segregation of duties and internal controls in all key business functions?*
- *Have we identified any material weaknesses due to limited resources and implemented alternative practices to minimize risk and provide adequate safeguards?*
- *Do we have an effective, independent internal audit function?*
- *Are internal audit findings and recommendations reported directly to the Audit Committee and included in their report to the board?*
- *Do we follow-up to ensure that all weaknesses are properly evaluated and recommendations appropriately implemented?*