
High Risk Areas in Credit Unions and Caisses Populaires

INTRODUCTION

This document has been developed to provide information for management and the audit committee when considering and reviewing their internal control structures, policies and business practices and establishing the scope of the external audit engagement for the credit union¹. These items may also be considered by the auditor in planning and performing the audit.

The areas outlined in Appendix 1 of this document are areas considered high risk areas within credit unions. These include areas relating to sound business and financial practices and impaired loans as outlined in DICO's by-laws. When discussing the overall audit strategy with the external auditor, the Audit Committee should obtain an understanding of whether any of these areas have been considered in the audit plan.

Credit unions with a robust internal audit program may likely address many of these high risk areas as part of their on-going reviews.

DICO places significant reliance on the work of the external auditor in reporting any material issues that have come to their attention when conducting the annual audit engagement.

In accordance with Section 172 of the Credit Unions and Caisses Populaires Act, 1994 (the "Act"), the auditor is required to report any transaction or conditions, that have come to the auditor's attention adversely affecting the credit union that in the auditor's opinion, are not satisfactory and require rectification, including any circumstances that indicate there may have been a contravention of the Act or Regulations. Please refer to the section "Duty of External Auditor to Report a Contravention" below which outlines derivative reporting requirements of external auditors. Some of the items included in Appendix 1 may be reportable under these audit guidelines.

DICO would like to thank the Institute of Chartered Accountants of Ontario and the Auditor Advisory Committee for the assistance they have provided in the development of this guidance.

¹ References to "credit union" means a credit union or caisse populaire incorporated under the Act

EXTERNAL AUDIT REPORTING REQUIREMENTS

DICO and FSCO place significant reliance on the work of the External Auditor for the purpose of assisting them in carrying out their duties and powers under the Act as outlined in section 169.

Auditor's Report – s. 169

- (1) *The auditor shall make such examinations as will enable the auditor to report to the members of the credit union in accordance with this section.*
- (2) *The auditor shall report to the members on the financial statements to be placed before them at the annual meeting.*
- (3) *If the auditor's report is not an unqualified report, the auditor shall state in the report the reasons for the qualified report.*
- (3.1) *Within 10 days after the annual meeting, the auditor shall provide a copy of the audited financial statements and the auditor's report to the Superintendent and the Corporation for the purpose of assisting them in carrying out their duties and powers under the Act, including, without limiting the generality of the foregoing, for the purposes of the following:*
 1. *Determining whether conditions on the deposit insurance of the credit union should be imposed or amended under section 270.*
 2. *Determining whether the deposit insurance of the credit union should be cancelled under section 274.*
 3. *Determining the annual premium for the credit union under section 276.1.*

AUTHORITY OF DICO

Pursuant to the Sections 171 and 171.1 of the Act, DICO and the Superintendent have the power to require the External Auditor to perform specific audit procedures or expand the scope of their audit engagement. As a result of the audit and information brought to DICO's attention and pursuant to Sections 171 and 171.1 of the Act, DICO or the Superintendent may require the auditor of a credit union to report on the extent of the auditor's procedures in the examination of the institution's financial statements, enlarge or extend the scope of that examination, or perform any other specific procedures. This may require a special engagement between the credit union and the auditor, with reporting based on a framework available to public accountants under the applicable professional standards and with clearly defined and agreed upon criteria between the auditor and DICO.

Extended Examination – s. 171 and 171.1

s.171.1:

The Corporation may exercise the powers of the Superintendent under section 171 and, for that purpose, the references to the Superintendent in section 171 shall be deemed to be references to the Corporation.

s.171 (1):

The Superintendent may, in writing, require that the auditor of a credit union,

- a) report to the Superintendent on the extent of the auditor's procedures in the examination of the credit union's financial statements;*
- b) enlarge or extend the scope of that examination; or*
- c) perform any other specific procedure.*

DUTY OF EXTERAL AUDITOR TO REPORT A CONTRAVENTION

In accordance with Section 172 of the Act, the auditor is required to report any transaction or conditions that have come to the auditor's attention adversely affecting the credit union that, in the auditor's opinion, are not satisfactory and require rectification, including any circumstances that indicate there may have been a contravention of the Act or Regulations.

Assurance and Related Services Guidelines (AUG) 13, Special Reports on Regulated Financial Institutions, and AUG 17, Transactions or Conditions Reportable Under the "Well-being" Reporting Requirement" in Federal Financial Institutions Legislation, provide guidance for external auditors regarding derivative reporting requirements of regulated financial institutions.

Duty to Report a Contravention etc. – s. 172

- (1) The auditor of a credit union shall report in writing to the chair of the board and to the audit committee of the credit union any transaction or conditions that have come to the auditor's attention adversely affecting the credit union, that in the auditor's opinion, are not satisfactory and require rectification.*
- (2) Without restricting the generality of subsection (1), the auditor shall report on,*
 - a) transactions of the credit union that, in the auditor's opinion, have not been within the powers of the credit union;*
 - b) loans made by the credit union to any person the aggregate amount of which exceeds one half of one percent of the total assets of the credit union and in respect of which, in the auditor's opinion, loss to the credit union is likely to occur; or*
 - c) any circumstances that indicate that there may have been a contravention of this Act or the regulations.*
- (4) If an auditor reports under this section,*
 - a) the auditor shall transmit the report, in writing, to the chair of the board and to the audit committee;*
 - b) the report shall be presented at the first meeting of directors following its receipt;*
 - c) the report shall be incorporated in the minutes of that meeting; and*
 - d) the auditor shall, at the time of transmitting the report pursuant to clause (a), provide the Superintendent and the Corporation with a copy of the report.*

HIGH RISK AREAS IN CREDIT UNIONS AND CAISSES POPULAIRES

The following areas are those considered as high risk areas within credit unions². These include areas relating to sound business and financial practices and impaired loans as outlined in DICO’s by-laws.

| Areas of Concern: High Risk Areas |
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| Corporate Governance Activities |
| Reports are not provided for each Board meeting that address: <ul style="list-style-type: none"> • Capital • Liquidity Risk Management • Market Risk Management/Investments • Credit Risk Management • Operational Risk Management • Compliance |
| The Board and Audit Committee minutes are not signed |
| The annual business plan has not been approved |
| Material variations to the annual budget have not been identified and appropriately addressed |
| The Audit Committee has not addressed all issues and recommendations relating to the last management letter, last audited financial statements, and last DICO Examination report |
| The Board does not review financial statements to ensure compliance with required minimum ratios as required by the Act, Regulations and Guidelines for Credit Unions. Actions to address non-compliance are not addressed in the Board minutes |
| The internal audit program is not based on an effective documented audit plan |
| Each branch is not included in the internal audit program according to a frequency model based on risk |
| Lending Activities |
| Loans do not fall within policy parameters |
| Loan and mortgage documentation do not meet policy requirements |
| Restricted party loans/mortgages are not approved by the Board |
| Loans appear on the loan trial balance with an extended payment due date without appropriate rationale provided by management |
| Loan trial balance ledgers do not reconcile to the aggregate amounts reported on the general ledger |
| Annual risk-based reviews are not completed for lines of credit |
| Lines of credit do not operate in accordance with terms and conditions |
| Non-filing insurance is not obtained where appropriate |
| Loans are underwritten, approved and disbursed by the same individual |
| The sources of large value loan repayments are not confirmed |

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| Connected party obligations are not recorded on the loan application |
| Controls are not in place to track connected persons |
| Unsecured or under-secured lending represent material amounts on the balance sheet |
| The level of unsecured or under-secured lending is not appropriately monitored |
| Delinquency |
| There is no active and effective delinquency management process that includes documentation of all collection efforts |
| Delinquency is not accurately reported |
| Where no delinquency report is generated by the data system, confirmation of a process to determine the accuracy of delinquent accounts has not been established |
| The value of security for impaired loans is not current and is not based on reliable sources |
| Loan write offs have not received proper approvals |
| Seriously delinquent loans are not assigned to collection agencies or law firms as may be appropriate |
| Interest Rate Risk (IRR) |
| Interest rate risk is not accurately measured in accordance with policy and DICO's Guidance notes |
| The interest rate risk methodology used is not appropriate for the structural risks of the credit union |
| Deposits |
| Large withdrawals in excess of \$10,000 are not appropriately managed and authenticity confirmed |
| The level of uninsured deposits is not accurately reported |
| FRONT OFFICE OPERATIONS |
| Teller Operations |
| Individuals hold excessive amounts of cash under his/her sole custody |
| Tellers are not assigned unique teller numbers |
| Managerial Duties |
| Surprise cash counts are not conducted on each teller on a frequent basis and at different days during the month |
| The surprise teller cash count blotters are not held in a separate file or recorded separately in a register |
| Personal Accounts |
| The following information is not obtained for all new membership files. (Documentation should be in accordance with FINTRAC Guideline 6 of the Proceeds of Crime (Money Laundering) and Terrorist Financing Acts (PCMLTF Act)) |
| <ul style="list-style-type: none"> • Record of primary photo identification (e.g. driver's license, passport, ID per Anti-Money Laundering and Terrorist Financing Acts) |
| <ul style="list-style-type: none"> • Signature card |
| <ul style="list-style-type: none"> • Signed account operation agreement (terms and conditions) |
| <ul style="list-style-type: none"> • PEFP, AML/ATF (anti money laundering, anti terrorist Act) , 3rd party question (know your client legislation) |
| <ul style="list-style-type: none"> • Purpose of Account |

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| <ul style="list-style-type: none"> • Occupation |
| <ul style="list-style-type: none"> • Source of initial deposit |
| <ul style="list-style-type: none"> • Other documentation depending on the type of account |
| Business Accounts |
| <p>The credit union does not require all of the following documentation be obtained prior to opening business accounts: (Documentation should be in accordance with FINTRAC Guideline 6 of the Proceeds of Crime (Money Laundering) and Terrorist Financing Acts (PCMLTF Act))</p> |
| <ul style="list-style-type: none"> • Operation of Account Agreement and/or Signature Card(s) |
| <ul style="list-style-type: none"> • Sole Proprietorship Agreement or Partnership Agreement or Certificate of Incorporation or other document to validate the existence of the organization |
| <ul style="list-style-type: none"> • Photocopy of Business Registration |
| <ul style="list-style-type: none"> • Signing Authority Resolution |
| <ul style="list-style-type: none"> • Borrowing Resolution (if required) |
| <ul style="list-style-type: none"> • Photocopy Articles of Incorporation |
| <ul style="list-style-type: none"> • List of Directors |
| <ul style="list-style-type: none"> • List of shareholders holding >25% of the shares |
| BACK OFFICE OPERATIONS |
| Treasury |
| <p>Surprise cash counts (complete cash reconciliations, not bundle counts) are not conducted on the treasury in the presence of the Treasury Officer, by a supervisor at least four times per year and documented</p> |
| Other |
| <p>Changes in the status of inactive or dormant accounts in the last three months are not validated and authorized by two individuals</p> |
| <p>There is no effective follow-up process for dormant accounts</p> |
| <p>Manually posted activity on a dormant account does not require a supervisor override</p> |
| Accounting Practices |
| <p>There have been instances of internal or external fraud</p> |
| <p>Two authorized staff members are not required to sign all corporate cheques</p> |
| <p>The investment report is not reconciled to statements from brokers and the balance sheet</p> |
| <p>Suspense accounts and internal operating accounts are not reconciled and/or outstanding items are not reviewed by senior management</p> |
| Information Management and Security |
| <p>Information provided by the system is timely and accurate</p> |
| <p>A back-up of the system is not completed daily and retained off-site</p> |
| <p>Access to the credit union data/accounting system is not controlled through an effective password, key or card access system</p> |

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| Employees are not explicitly prohibited from sharing any assigned passwords |
| Passwords are not robust and do not follow industry standards (ISO 17799) with respect to the setting of password characteristics regarding changing, reuse, length, composition, history, etc. |
| The credit union does not have a user hierarchy which restricts employees from access to accounts other than those related to their functions |
| User hierarchy is not reviewed annually to ensure access rights are appropriate and do not lead to a poor segregation of duties |
| Changes to access rights are not independently reviewed by someone other than the system administrator who made the change |
| The system does not prevent tellers from accessing their own accounts or those of parties related to them |
| The General Manager does not review all transactions performed by the system administrator |
| All third party providers identified do not have current and signed: <ul style="list-style-type: none"> • Contracts • Non-disclosure (confidentiality) agreements |
| The System network and website do not undergo a review of firewall parameters and penetration tests. |
| Business Continuity Plan(BCP)/Disaster Recovery Plan (DRP) Activities: <ul style="list-style-type: none"> • The DRP and BCP have not been tested in the past 12 months • The DRP and BCP have not been approved by the Board |