

What Are Internal Controls?

This module defines the concept of internal controls and examines internal control components, fraud, responsibilities, and ethics.

Over the course of seven years, the president of a small credit union in the South Central United States systematically embezzled hundreds of thousands of dollars by originating more than 100 loans through dormant and decedent accounts. When her actions were finally detected, the woman was sentenced to 71 months in prison and ordered to pay restitution of more than \$2 million—which works out to almost half the assets of the \$5 million credit union. The credit union was declared insolvent and taken over by a larger financial cooperative.

The preceding true story is just one example of the many types of fraud and errors internal controls are designed to prevent and detect. **Internal controls** are a collection of interconnected processes that, as a whole, make up a system intended to protect the assets of the financial institution—in this case, your credit union—by discouraging fraud on the part of employees and members, preventing errors, and enabling the earli-

est possible detection of any fraud or errors that do occur. Internal controls are a standard aspect of all systems—accounting and auditing, information technology, human resources, and security—that apply to the finances and secure operations of government agencies, privately and publicly held companies, and financial institutions, including credit unions.

In credit unions of all sizes, the **Supervisory Committee**—or as it is known to some state-chartered credit unions, the Audit Committee—is the statutory body tasked with the responsibility of making sure sufficient, effective internal control systems are in place and enforced. In larger credit unions, the Supervisory Committee works in concert with an **internal auditor**, management, and **external auditors** to get the actual work done. In the smallest credit unions, the Supervisory Committee may have the responsibility of doing some or all the work itself.

This module defines the concept of internal controls and examines internal control components, fraud, responsibilities, and ethics. This first chapter briefly defines internal controls and discusses how they fit into the overall picture of credit union management and operations.

Internal Control Defined

Internal control is a process instituted by a credit union's board of



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directors, Supervisory Committee, management, and other personnel with the foremost aim of protecting the organization's assets. According to the NCUA's *Supervisory Committee Guide*:

Internal controls include the staff structure, operating procedures, and other measures within the credit union to:

- Safeguard assets;
- Check the accuracy and reliability of accounting data;
- Promote efficiency; and
- Encourage compliance with board policies.

Internal controls minimize the possibility that errors or fraud remain undetected for any length of time. Internal controls can also help prevent errors.

Thus, internal controls are designed to provide reasonable assurance that the credit union's objectives are achieved in the following categories:

- **Effectiveness and efficiency of operations** to achieve basic business objectives, including performance and profitability goals, safeguarding resources, and to provide the necessary information for the board and Supervisory Committee to ensure that the credit union's operational objectives are being met;
- **Reliability of financial reporting** from the preparation of published financial statements, including interim and condensed financial statements, to earnings reports and other internal financial data; and
- **Compliance with applicable laws and regulations**, including all

federal and state laws, rules, and regulations.

Basically, internal controls can be thought of as a series of checks and balances for the credit union. With that concept in mind, consider these aspects of instituting and maintaining effective internal controls:

- Internal controls are a process—a means to an end rather than an end in and of themselves. The desired end is an assurance that the credit union is in good hands and is being operated safely and soundly on behalf of its members. That requires constant vigilance and adaptation to identify and respond to new threats.
- Internal controls are all about people. Controls may be spelled out in policy manuals and forms, but they are enacted by people at every level of an organization.
- Effective internal controls provide reasonable assurance, not absolute certainty that fraud and errors will not occur. Audits and reviews of internal controls can only test a representative sampling of most types of controls; even detailed reviews cannot catch every eventuality.
- Internal controls are geared to the achievement of objectives in separate but overlapping categories. Do all cash activities reconcile to the penny? Are all money orders, cashier's checks, and traveler's checks accounted for? Is the person who approves a loan application different from the person who disburses the loan proceeds?

Hard vs. Soft Controls

Internal controls consist of both hard and soft measures:

- **Hard controls** refer to policies, procedures, and systems designed to prevent fraud and error. For example, requiring a **separation of duties** ensures that the individual who approves a loan isn't the same individual who disburses the loan funds.
- **Soft controls** refer to the competency, integrity, and commitment to honesty and accuracy by employees, managers, volunteers, and consultants and business partners. Examples of soft controls are supervisors who monitor and model proper cash handling techniques, active oversight by the Supervisory Committee, and an objective internal audit function.

Hard and soft controls go hand-in-hand. Hard controls bring together the sum of considerable experience about

the best ways to prevent and detect fraud, but employees who set their sights on larceny may be able to find a way around those checks and balances. Along the same lines, the most honorable employees may have a hard time “thinking like the bad guys” to foresee and head off fraud. The combination of well-thought-out and up-to-date policies and procedures carried out by employees and volunteers who are committed to both the aim and the letter of those guidelines provides the best path to effective internal controls.

Figure 1.1 outlines what internal controls can and can't do for a credit union.

How Internal Controls Function

The primary objective of internal controls is to protect the credit union from loss by preventing dishonesty and costly mistakes. This aim is accomplished by creating a system of checks and balances that minimizes loss. Internal controls are a shared responsibility involving all parties in the credit union—the board of directors and Supervisory Committee, executives and managers, frontline and back-office employees, and outside parties and business partners, including the external auditor.

Internal controls generally fall into two categories: accounting and administrative controls. **Accounting controls** encompass the credit union's financial recording system, from its daily posting of transactions that are reconciled for locating and correcting errors, to its weekly, monthly, quarterly, and annual financial reports for internal

Figure 1.1

What Internal Controls Can and Can't Do

Internal controls can:

- Help the credit union achieve performance and profitability targets
- Prevent loss of resources
- Ensure reasonably reliable financial reporting
- Ensure compliance with laws and regulations
- Protect the credit union from damage to its reputation or other consequences

Internal controls cannot:

- Ensure a credit union's success, or even its survival
- Transform an inherently poor manager into a good one
- Provide absolute assurance that management and board objectives will be realized

Accounting and administrative controls sometimes overlap, and, like hard and soft controls, are interdependent.

use and reporting to members and examiners. These records and systems are designed to provide an **audit trail** so that each transaction can be traced from inception to completion.

Administrative controls refer to policies and procedures implemented and monitored by managers to establish lines of authority and responsibility; ensure that written policies are followed; segregate duties and implement dual controls so that two or more persons are involved in a transaction to head off the potential for fraud; and develop hiring and personnel policies that support the aim of internal controls.

Accounting and administrative controls sometimes overlap, and, like hard and soft controls, are interdependent. Let's take a look at several common examples of internal controls that demonstrate these concepts in action.

Example of separation of duties (accounting control/hard control): The employee who enters the final reconciling general ledger changes is not the same employee who approves the general ledger accounts. Even though one person could in theory handle both processes, segregating the

responsibilities offers an assurance that a single employee won't be tempted to approve inappropriate entries and then disburse the money and keep it. In other words, an internal control calling for the involvement of two people lessens the opportunity for fraud and loss.

Example of conflict of interests (administrative control/hard control): Employees are not permitted to process their own or family members' financial transactions. Having an unrelated employee handle these transactions lessens the temptation and opportunity for fraud. An unrelated employee is less likely to understate the amount of interest due on a loan payment, for example, or overstate a deposit by a small amount that might be written off when the accounts are balanced at the end of the day. Internal controls are designed to identify the potential conflict between an employee's or volunteer's personal and family interests and his or her responsibility to the credit union.

Example of professional development requirements (soft control): Credit union employees may be required to achieve a specific level of education to qualify for promotion or transfer to another job or department. The credit union may also encourage employees to take advantage of continuing education opportunities or to pursue certification and degree programs, such as a CPA designation or MBA. Continuing education as a credit union policy enhances an employee's knowledge of his or her responsibilities to the credit union.

These are just a few examples of



Figure 1.2**Hierarchy of Internal Control Development**

the types of policies in place at credit unions with effective internal controls. Policies are enacted in a series of increments called processes, procedures, and steps.

Policies, Processes, Procedures, Steps

Internal controls tend to be based on industry standards adapted for the credit union's asset size, employment base, operations, infrastructure, and management and governance structure. These controls become a well-established part of the operations and audit system. The larger the credit union, the more internal controls are required and the more complicated they are, but even the smallest credit union must have functional internal controls in place. Writing the internal control policies is the first step in enacting internal controls, followed by the development of processes, procedures, and steps (figure 1.2). Let's examine this hierarchy of developing and implementing internal controls.

Policies

To be useful, internal controls must be written so that anyone can refer to them and everyone has a clear and shared understanding of the controls. Written policies override individual personalities and perspectives, making the policies applicable to everyone

equally.

A **policy** is a statement of direction or method that guides and determines present and future decisions. Written policies dictate when and where to look for internal controls (for example, in ensuring proper loan approval and disbursement), what to do in case of exceptions (as in when activities can't be divided between two people at a very small credit union), and who is responsible for developing and enacting the policies (for example, management writes draft policies and presents them to the Supervisory Committee, which reviews them prior to presenting them to the board for approval).

Written policies offer assurance that the external auditor and examiner will be able to identify all internal controls and that employees understand their responsibilities as they relate to fraud and error prevention and have a ready reference when they have questions.

Outside auditors and examiners review, test, and critique the written internal controls as part of the review of the credit union's policies and processes. Missing internal controls are a red flag for possible loss or fraud and will be examined in detail and highlighted in the auditor's or examiner's final report to the Supervisory Committee and board of directors.

Developing policies is only the first step of maintaining effective internal controls. Those policies must be imple-

mented through a series of processes, procedures, and steps. The Supervisory Committee is responsible for overseeing the policies, while the various levels of management are responsible for ensuring that the policies are translated into processes, procedures, and steps for full implementation.

Processes, Procedures, and Steps

A **process** is a collection of related, structured activities, or procedures, that lead to a desired end. One or more processes make up the action steps in a policy. A **procedure** is a fixed sequence of activities that must be followed in the same order to correctly perform a task. **Steps** are the smallest increment, the detailed activities that comprise a procedure. In outline form:

1. The policy sets out the credit union's philosophy or allowable activities.
 - a. Process A comprises Procedures X, Y, and Z.
 - b. Procedure X comprises steps x1, x2, x3, x4, and x5.

This hierarchy permits an organized, easy-to-follow approach to developing, implementing, disseminating, and maintaining internal controls.

Let's look at one example:

Policy: Signature loans are allowed up to a term of 5 years. We recommend that borrowers make their repayment by direct deposit. (*This policy mandates an internal control—a five-year limit on unsecured loans with a recommendation for repayment by direct deposit.*)

Process A: Review a member's application for a signature loan for approval or denial. (*A process defines the means for carrying out the internal control.*)

Procedure X: Review the application. (*A procedure details how the internal control is carried out.*)

Step x1: Verify all information is complete.

Step x2: Verify member's personal information.

Step x3: Request a credit bureau rating.

Step x4: Verify income.

Step x5: Approve or deny the loan based on credit union criteria.

Process B: Complete loan papers.

Procedure Y: Provide member with required forms and disclosures.

Procedure Z: Complete direct deposit form for loan payments.

Step y1: Obtain signature on form.

Step y2: Fill in appropriate loan payment.

Step y3: Give a copy to member.

Step y4: Send copy to accounting department to set up direct deposit.

Internal control policies may be written by management and/or the Supervisory Committee and are

Figure 1.3

Internal Control Process Summary

Loan Disbursement Cycle

- There is a formal member loan process in place.
- The person processing the loan application is separate from the person disbursing the loan proceeds.
- An appropriate system is in place for review and approval of the individual loan files.
- Loans are approved for disbursement.
- The loan disbursement GL account and list of member loans payable are reconciled regularly.

Processes are defined by mid-level management or supervisors.

Procedures and steps are defined by supervisors.

approved by the board of directors. Processes are defined by mid-level management or supervisors. Procedures and steps are defined by supervisors.

Figure 1.3 shows another example of a series of processes related to internal controls which establish a policy for the accounts payable disbursements cycle.

The Return on Internal Controls

The example that opened this chapter shares the story of a credit union CEO who systematically stole more than \$2 million by falsifying loans made on dormant and decedent accounts. This story is stunning both in the amount stolen from a small credit union and in the length of time—from 2001 through May 2008—over which the fraud occurred. If this credit union had effective internal controls in place, the embezzlement might not have occurred. At the least, it would have been detected much more quickly.

The fate of this credit union—

insolvency—is neither unexpected, given the size of its loss, nor unusual. As CPA Alyssa Martin notes in an August 2008 article in *Credit Union Magazine*:

Business disruption accompanies fraud investigations, as do possible lawsuits and criminal charges. Although more difficult to quantify, the long-term losses of confidence and trust among all stakeholders may be the highest costs organizations face when exposing fraud. Recovering from those losses can take years, and sometimes the damage is so severe that recovery isn't possible.

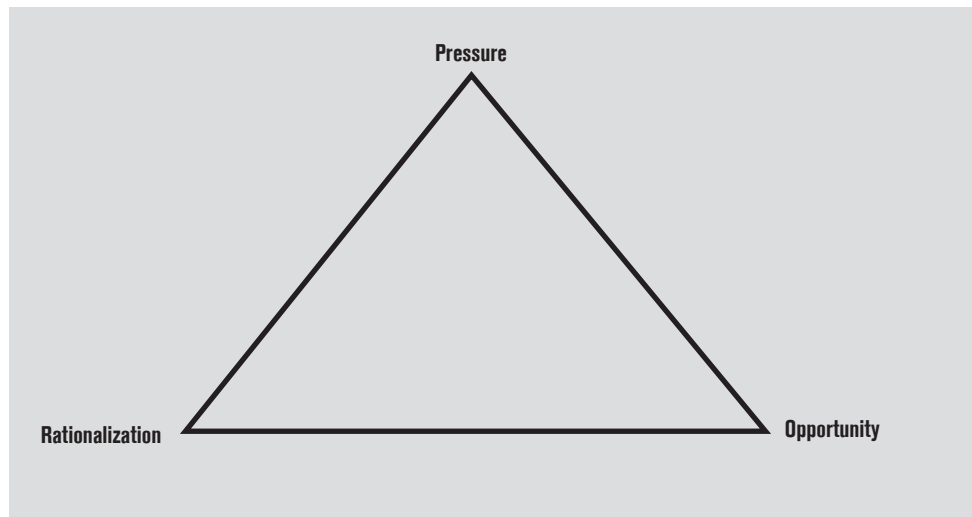
The return on effective internal controls then, is to head off the loss of funds, business disruptions, and damage to reputation and trust that result from fraud and serious errors. It is impossible to put a price tag on prevention, but it is not overstating the case to say that your credit union's future rests on the development, implementation, and continuous review and fine-tuning of effective internal controls.



The Fraud Triangle

Accounting, auditing, and security professionals often refer to the **fraud triangle** in explaining the three elements that are in place when fraud occurs (see figure 1.4):

1. **Pressure** to obtain money by whatever means. People who steal from their employers may be driven by personal emergencies, such as high medical bills or a gambling addiction, or they may be motivated by greed or the desire to maintain a lifestyle

Figure 1.4**The Fraud Triangle**

- beyond their means.
2. **Rationalization.** Succumbing to the pressure to commit fraud hinges on how the person justifies his or her actions. Embezzlers may cite a variety of excuses:
 - “I had to do it to pay for my child’s medical expenses.”
 - “I would have lost everything—my home, my car, my family—if I didn’t come up with the money.”
 - “I had no where else to turn.”
 - “It was just a loan. I was going to pay it back.”
 - “I deserved it. I put my life into this job, but I was never paid or recognized adequately for all my effort.”
 - “I warned my boss how easy it would be to steal from the credit union, but no one listened. I guess I showed them.”
 3. **Opportunity**, or the means and ability to commit fraud without detection. Opportunity results from weak internal controls, lack

of oversight, and abuse of the power of one’s position.

Of the three points on the fraud triangle, opportunity is the element over which credit unions have the most control. Certainly, soft controls such as hiring honest employees and fostering an environment that values integrity aim to winnow out employees and volunteers who feel pressure and can rationalize their urge to steal from the credit union. However, maintaining effective internal controls that head off the opportunity to commit fraud is the surest path to prevention.

This chapter introduced the concept of internal controls and the general process of creating and operating these necessary controls from the policy level of the board, Supervisory Committee, and management to step-by-step procedures for frontline and back office staff. In chapter 2, we will expand on these basic concepts by exploring the five management-level components of internal controls.