

## How to Use This Manual

*NAFCU's Internal Controls for Credit Unions* addresses issues related to implementation and management of internal control systems. In the manual are examples of policy and procedures that provide a range of management resources to help you and your credit union's management team design, develop, implement, and maintain a proactive risk management supervisory system of internal controls. The manual focuses on different scenarios. For example, your situation may involve implementing an integrated system in your credit union or in a specific department. Other challenges may exist, such as establishing formal guidelines for an existing internal control system and related processes.

### ADDRESSING TODAY'S INTERNAL CONTROL CHALLENGES

The manual focuses on basic challenges for credit union management today:

- How does a credit union management team detail what internal control systems exist?
- If control systems exist, how does an officer or manager determine whether those controls or systems are working?
- How can senior management ensure that internal control systems will be created as needed or specific work flow situations change?
- How do you build flexible controls with appropriate exception tracking systems?

The challenges are further complicated by changing financial institution structures, new regulatory requirements, increased competitive pressures, consolidation of operations, development of new or enhanced products and services, and changing technology. It seems like an impossible task! However, with this manual, we provide basic conceptual corporate governance guidelines, which, through staff accountability and individual understanding of the importance of internal control systems, can capture even the most frequent changes or newest ideas within a viable internal control system. Supervisors and staff can ensure that the written procedure or specific control works. From the top down, however, there must be an overall commitment to a well-run, safe, and sound organization. Cutting costs, reducing staff, and shortcutting controls may save money in the short run, yet leave the credit union vulnerable to serious problems in the near future.

### FOCUS ON INTERNAL CONTROLS

The systems of internal controls exist to assure the achievement of intended results, to promote operating efficiency, and to encourage compliance with policies and other established constraints. Management's primary concern must be the continuing effectiveness of the systems of internal controls that influence business results. The important qualities that must be periodically evaluated are adequacy, effectiveness and efficiency.

In evaluating adequacy, management should ascertain whether systems include design features proper to the circumstances and reasonably sufficient to effect control. The evaluation of adequacy begins with the comparison of "what should be" to "what is." Initial implementation of internal controls systems with respect to supporting proposed procedures, should ensure the adequacy of control within the organizational structure.

In evaluating effectiveness, management should ensure compliance with internal control features and the extent to which compliance serves the intended purposes. The question that must be answered is: *Do the controls work?*

In evaluating efficiency, management should assess the practicality of controls in terms of their cost relative to their intended benefit. It is not advisable that management judge internal control efficiency in absolute terms. An evaluation of internal control efficiency is restricted to the controls themselves and does not extend to the measures of operating performance associated with the functioning of such controls. In judging efficiency, management should consider whether the benefits provided by the controls exceed their cost.

The systems of internal controls (including procedures) should address the following:

- Provide reasonable assurance that assets are safeguarded, information (financial and other) is timely and reliable, and errors and irregularities are discovered and promptly corrected.
- Promote operational efficiency.
- Encourage adherence to managerial policies, laws, regulations and sound fiduciary principles.

Members of management who are responsible for policy implementation are also responsible for the design and the maintenance of the systems of control. As a follow-up independent review, internal auditors are responsible for that management function which independently evaluates the adequacy, effectiveness and efficiency of the systems of controls. Internal auditors should make sure that those who rely on their opinions understand that no practical system can guarantee the quality of future performance.

Internal controls should act as a positive force to facilitate successful operations, as well as a negative one that restricts activities. Accordingly, management should evaluate control systems in terms of the incentives they provide, as well as the sanctions. Safeguarding assets relates to physical, legal and all other protective means by which the financial institution assures the full realization of its resources.

All information should be subject to the systems of internal controls. Timely information is a critical monitoring reporting component which anticipates a decision need and is available to the persons who will use it when they need it. Reliable information provides a sound basis for decision because of the authenticity of its source, the manner in which it is recorded and the form and content of its presentation.

The systems of internal controls must detect and correct errors and irregularities when preventive controls fail. Sound systems of control contain safeguards that will counteract failures in other controls. The systems of control should promote operational efficiency. The features of control systems that promote operational efficiency include the processes used to select and train personnel, establish procedures, set performance requirements, measure results and provide incentives.

Managerial policies, laws, regulations and sound fiduciary principles establish boundaries within which the financial institution can conduct its business. The features of the internal control system that encourage compliance with these requirements include the separation of duties, the employment of persons likely to comply, the establishment of authority limits and the communication of expected conduct.

### **Top-Level Support <sup>1</sup>**

Why focus on top-level controls? Everything flows from the top. Controls at the organizational level can have an encompassing influence over controls at the process, transaction, or application level. Controls that apply to all locations and business units help to set consistent standards and expectations across the institution.

Organizational-level controls include governance elements that establish the benchmarks or directives at the highest level of the institution. These basic elements include:

- Policies

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1. Adaptation of concepts presented by Deloitte and Touche, LLP, *SOX Optimization: Improving Compliance Efficiency and Effectiveness*, September 2007.

- Procedures
- Codes of conduct including details on conflicts of interest
- Assignment of authority and responsibility
- Risk assessment processes
- Identifiable controls that monitor other controls, such as oversight and assessment of the internal audit function, the audit committee, and employee self-assessment and fraud prevention activities, such as whistleblower hotlines, which can have an indirect relationship to financial statement misstatement risk

Many institutions have the opportunity to increase their reliance upon organizational-level controls that can directly mitigate financial statement misstatement risk, such as controls over the period-end financial reporting process. Similar controls include monitoring controls such as analytical review and budgeting; and controls governing centralized processing, such as shared service environments.

To ensure top-level controls or organizational controls are fully implemented, identifiable, and consistently communicated, it is important to undertake a procedural approach to reviewing the present control environment, with steps that include the following:

- Understand the overall design and balance of controls and how they align with financial reporting risks.
- As appropriate, flexibility to shift focus toward higher risk areas to enhance compliance quality.
- Support to achieve cost savings by applying more efficient compliance efforts for routine processing-related controls.
- Identification of how organization-level (as opposed to individual process-level) controls can be improved to drive compliance efficiencies and reduce the institution's overall compliance risk profile.

The internal control checklists are a critical tool to assist in the identification of organizational-level controls and areas where further controls will reduce the institution's overall compliance risk profile.

## **REGULATORY CONCERN**

The importance of internal control systems and the level of supervision of internal controls have become a regulatory concern. The Federal Financial Institutions Examination Council (FFIEC) has detailed this concern through various issuances of interagency policy statements pertaining to controls and technology. Further, each agency has issued specific internal control system guidance on the need to enhance controls and support proper internal management systems. Examiners will be taking a much closer look at internal control systems' processes and performing a more detailed review of actual controls. The regulatory emphasis translates to a very real concern for credit union directors and management.

## **PREPARING FOR EXAMINATIONS**

Your credit union may not be at risk today, and it may not even have a specific concern regarding internal control systems. However, various aspects of your next examination will focus your management team's efforts on properly addressing risk management. These examinations will be checking your risk management approach, and examiners will also be correlating risk issues or risk exposures as they are detected throughout the organization. You will reduce your regulatory risk by taking time now to prepare a corporate approach to internal control system processes, reviewing plans for further changes in data flow or system processes which result in internal control changes, and even moving toward a more automated internal control exception tracking system. Analyzing your risk exposure and making enhancements before the start of your next examination will undoubtedly have a positive impact on the examination results.

## **TOOLS FOR ADDRESSING SOLUTIONS**

The manual offers insights and hints not only on evaluating the concepts of risk management and development of internal control systems to address those risks, but also on dealing with other issues such as internal controls design, detailing internal controls, implementing alternatives, assessing risk positions for each type of control risk, developing formal internal control policy and procedures, and implementing systems to ensure ongoing proper control and oversight. Also included in the manual are internal control monitoring worksheet questionnaires; these questionnaires are critical tools to help supervisors perform in-depth analysis and plan action steps. The manual provides guidance on a whole range of operational issues to encompass even specialized activities that may affect only a few credit unions. By using this manual, management team members will not only become aware of existing internal controls, important internal control system components, and development processes, but also will gain an understanding of the applicable regulatory issues and examination focus points. Risk management processes are a critical management focus point of successfully implementing and maintaining a viable internal control system.

## **YOUR COMPANION CD**

As part of your subscription to *NAFCU's Internal Controls for Credit Unions* you receive a companion CD. This disc contains all of the information in your print manual that shows you how to make sure your internal controls are established and accomplishing what they were intended to do.

Insert your CD into your desktop computer, and the autoplay feature will assist you in navigating the files. You can search quickly and easily for specific guidance and policies.

## **Customize Your Controls**

From credit risk to integrated financial software systems, the CD contains sample internal controls for every key area of the institution, checklists, examples of documentation, and clear guidelines you can use for your own controls for your operation.

You can easily customize the documents on the CD using Microsoft Word so that you keep your banking functions current with the latest compliance issues. Sample internal controls checklists are provided for each key area that you can easily adapt to your institution's specific requirements.

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