



## ***DCU BULLETIN***

***Division of Credit Unions***

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### **Internal Audit**

#### **Internal Audit is Critical**

Volunteers and senior management are responsible for having an effective system of internal controls. They are also responsible for ensuring that the importance of internal control is understood and respected throughout the credit union. This overall responsibility cannot be delegated to anyone else. They may, however, delegate the testing and assessment of internal controls to others. Accordingly, volunteers and senior management should have reasonable assurance that the system of internal control prevents or detects significant inaccurate, incomplete, or unauthorized transactions; deficiencies in the safeguarding of assets; unreliable financial reporting (which includes regulatory reporting); and deviations from laws, regulations, and the credit union's policies.

The Supervisory Committee is assigned responsibility for the internal audit function. However as the credit union grows or becomes more complex in its operations, the Supervisory Committee should consider engaging the services of a qualified internal auditor.

Both the internal and external auditors play key roles in the monitoring of internal control systems in credit unions. Each credit union should have an internal audit function that is appropriate to its size, and the nature and scope of its activities.

Some credit unions have chosen to rely on so-called "management self-assessments" or "control self-assessments," wherein business line managers and their staff evaluate the performance of internal controls within their purview. Such reviews help to underscore management's responsibility for internal control, but they are not impartial. Volunteers and members of senior management who rely too much on these reviews may not learn of internal control weaknesses until they have become costly problems, particularly if volunteers are not intimately familiar with the institution's operations. Therefore, credit unions generally should also have their internal controls tested and evaluated by units without business-line responsibilities, such as internal audit groups.

The internal auditor is typically very involved in the program design, ongoing review, and assessment of a credit union's internal control mechanisms. When properly structured and conducted, internal audits provide directors and senior management with vital information about

any weaknesses in the system of internal control allowing management to take prompt, remedial action. The internal auditor can be the first line of defense against a weakened control system, through directed reviews of the internal control systems and as part of the regular audit program.

### **Benefits of Internal Audit**

Outside directors have a limited amount of time to devote to the oversight of the credit union. It is essential that they receive independent information about the credit union's performance. Generally, directors can rely on management to fix deficiencies once found. However, management may not always recognize deficiencies in operations and an independent perspective may be necessary to recognize a need for better controls. Internal audit reports should provide the board and supervisory committee with impartial information about the credit union's operations.

An internal audit function is important to assist in the design and development of new programs. They can ensure appropriate controls are in place to adequately monitor the risks of programs from implementation. Examiners expect credit unions with high risk of any type to have a greater emphasis on internal audit. For example, credit unions with significant levels of indirect lending, member business lending, credit card fraud, Banks Secrecy Act exposure, or information technology exposure should reevaluate their internal audit capacity. Examiners have been given the guideline that, typically, depending on complexity, an internal audit function is expected when the credit union assets reach \$100 million and a full-time on-staff internal auditor when assets reach \$300 million. However, regardless of size, credit unions should consider the need for an internal audit function.

To ensure impartiality, the internal auditor should report directly to the Supervisory Committee (committee), who should set audit staff compensation. Frequent, informal contacts between the internal auditor and the committee are desirable to discuss the audit plan, the findings, and the significance of the findings. The internal auditor should present findings to the board or committee, along with management on how deficiencies (if any) will be corrected.

### **Internal Audit Responsibilities**

Examiners will look for a strong internal audit function and should typically find the following elements within the internal audit program:

- Independence and objectivity.
- Assurances that controls are built into future operations and emerging risks, not just a look backwards.
- Qualified personnel to draw expertise and counsel during design and implementation of new programs.
- Adequate monitoring of the credit union's internal control system.
- Evaluation of the extent and effectiveness of the institution's compliance with its policies and procedures.
- Adequate testing and review of information systems.
- Adequate documentation of tests and findings of any corrective actions.
- Verification and review of management's actions to address material weaknesses.
- Reliability of the information produced by the institution, including reports to the National Credit Union Administration (NCUA), Division of Credit Unions, the board, and critical management reports.

- Protection of the institution's assets against loss.
- Recommend corrective actions and improvements in operations.

### **Smaller Credit Unions**

Examiners will recognize smaller credit unions (less than \$100 million in total assets) may not be able to afford a separate internal audit function but should provide for internal audits by other means, such as:

- Hiring an independent auditor.
- Hiring a part-time internal auditor or asking a larger neighboring credit union to provide internal auditing services.
- Establishing a dual compliance officer/ internal auditor function.
- Periodically requiring certain departments to review the work of other departments.
- Performing Supervisory Committee' audits of critical areas.

Examiners will work with smaller credit unions to determine how best to establish an internal audit function with limited resources and they will take into consideration the level of risk from complex products, services, and operations.

Please call Linda Jekel, Director of Credit Unions, at (360) 902-8778 if you have any questions or comments about this guidance.