

Memo

To: Board of Directors, Supervisory Committee, Internal Audit Department, and Management
From: North Dakota Department of Financial Institutions
Date: August 7, 2012
Re: Audit Function Guidance

The Department has received several inquiries related to the minimum audit procedures necessary to meet the auditing function requirements. While it is difficult to paint a single picture of the auditing function that fits into all credit unions' risk profiles, some common elements are present regardless of complexity. These included an audit of the financial statements, an internal audit function, internal controls, and a system of reporting weaknesses. The following is a general explanation of the Department's expectations for a credit union's audit function.

Financial Statement Audit and Account Verification

All credit unions are required to obtain an annual financial statement audit, and bi-annual account verification. This is most often an opinion audit performed by a CPA. The credit union's responsibility when obtaining a financial statement audit from a CPA is to perform adequate due diligence over the firm conducting the audit, and to ensure management has resolved any findings or weaknesses noted in the reports. Credit unions are encouraged to review their due diligence procedures over the process to ensure they are accurate and sufficiently satisfy the requirements of section 13-03-25 of the North Dakota Administrative Code.

A few smaller credit unions continue to utilize the Supervisory Committee to perform the financial statement audits and account verifications, or are obtaining a more limited non-opinion audit from a CPA firm. While it is realized that this is a means of limiting the cost of the audit and account verification, the increasingly complex nature of financial institutions is making it more and more difficult to find volunteers to adequately perform the function. It is also becoming more difficult for a CPA firm to obtain an accurate picture when performing a more limited engagement. The Department and the State Credit Union Board are strongly encouraging all credit unions, regardless of size, to outsource the financial statement audit and account verification process to a CPA firm and to obtain an opinion audit. This is especially important if recent examination reports have noted weaknesses in the accounting or audit process. If you choose to continue to have the Supervisory Committee perform the audit and/or account verification, the Department is requesting that you notify us of this fact, and explain the training the committee has received which qualifies them to perform a financial statement audit and account verification.

The Internal Audit Function

All credit unions regardless of size must have an internal audit function. Larger credit unions typically have an internal audit department, while smaller credit unions typically engage the services of a CPA firm to perform agreed upon procedures or have the Supervisory Committee perform these additional procedures. Regardless of who performs this function, the function supplements the financial statement audit and account verification to ensure ongoing monitoring of credit union operations.

Large and complex credit unions are strongly encouraged to establish an internal audit department. The size and experience level of the department should be consistent with the risk profile of the institution. The credit union should establish a structure that ensures independence and an audit program that conforms to Internal Auditors Standards for the Professional Practice of Internal Auditing. While not all inclusive for every credit union's risk profile, the attached list of Recommended Fraud Audit Procedures should serve as a starting point in establishing the audit program.

Credit unions that are smaller or less complex often hire a CPA firm or engage the Supervisory Committee to perform the internal audit function. Again while it is not all inclusive, the attached list of Recommended Fraud Audit Procedures should serve as a starting point for this process. The credit union should work with their CPA firm to ensure the agreed upon procedures adequately limit risk. If the Supervisory Committee is performing these services, they must have the proper training to effectively carry out these procedures and to limit risk.

If a credit union has complex operations such as business or real estate loans, or internal data processing systems or networks, the Department **strongly** encourages the credit union to periodically obtain a review of these complex areas by a qualified third party. This will help to ensure the risk in these complicated areas is adequately assessed and limited.

Internal Controls

Internal control processes make up the backbone of the risk mitigation process. Large credit unions are encouraged to develop systems of internal controls including dual controls and segregation of duties. Credit unions with limited staff need to ensure additional internal audit procedures are employed to limit the risk due to the lack of controls.

System of Reporting Weaknesses

Regardless of the party performing the financial statement audit and account verification or internal audit function, the credit union must establish a system of reporting the weaknesses to the Board of Directors, and a system to follow up on the weaknesses to ensure they are resolved in a timely manner. The Board of Directors and the Supervisory Committee should obtain written responses from management outlining the plan to resolve the weaknesses noted, as well as the projected timeframe for resolution. Once resolved, the internal audit department, Supervisory Committee, or CPA firm should conduct another review of the area to ensure the problem is resolved. A similar process should also be employed for following up on weaknesses noted during the Department's examinations.

Examination and CAMEL Component Implications

Examiners will be reviewing the financial statement audit, internal auditing process, and system of reporting weaknesses during examinations. Because one size does not fit all with respect to an audit function that fits into each credit unions' risk profile, we encourage you to discuss the entire risk mitigation process with the examiner to ensure their understanding of the process is complete. Any weaknesses in the process will be criticized in the examination report and will impact the management component of the CAMEL rating. Unresolved weaknesses from prior examinations may result in administrative action or rejection of the audit as outlined in 13-03-25-08 of the North Dakota Administrative Code and 6-06-01 of the North Dakota Century Code.

Regulation and Guidance

Regulations exist and guidance has been issued related to the audit and internal audit process. The following are some resources that may be useful when evaluating the Audit Function:

- North Dakota Administrative Code 13-03-25
- FFIEC's Interagency Policy Statement on the Internal Audit Function and Its Outsourcing
- NCUA's Supervisory Committee Guide
- NCUA's Examiners Guide, Chapters 4 and 5
- FDIC's Risk Management manual of Examination Policies section 4.2
- OCC's ICQs and Verifications Procedures