Volunteer Leadership Institute - Hawaii

ACCOUNTING & AUDITING – SECRET SAUCE OR JUST SECRETS?

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Learning Objectives

1. Learn the top 10 credit union audit and accounting risks and the control plan to counteract them.
2. Learn what auditors fear the most and why you should too!
3. Understand when a "clean audit" really means something is terribly wrong.
4. Learn the sneaky ways management can "cook the books" and contravene policy.
5. Understand importance of follow-up steps post-audit to ensure that recommendations are properly implemented, and improvements are made.

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Accounting & Auditing

Secret Sauce or *Just Secrets*?

Roger A. Jones, CPA, CGMA

- Founding partner of Hauser Jones & Sas PLLC (now Opsahl Dawson)
- 30+ years of expertise in accounting and credit union strategy
- Engaging speaker and teacher on governance, accounting, auditing, internal audit and compliance
- Active supporter of GoWest Credit Union Association and Foundation
- Firm specializes in elite audit, risk management and compliance services for credit unions in the Western U.S.

Overview

Explore the most common risks in credit union accounting and auditing.

Gain insights into the often-hidden truths that affect audits.

Understand how to mitigate risks and ensure proper follow-up post-audit.

Agenda

1. Top 10 Credit Union Audit and Accounting Risks
2. What Auditors Fear the Most
3. The Truth Behind a "Clean Audit"
4. Sneaky Ways Management Can Cook the Books
5. Importance of Post -Audit Follow -up Steps

Top 10 Credit Union Audit and Accounting Risks

Top Ten Audit Risks

Risk #1: Fraud

Risk #2: Inadequate internal controls

Risk #3: Insufficient documentation and record -keeping

Risk #4: Mismanagement of liquidity and cash flow

Risk #5: Non-compliance with regulatory standards (NCUA, GAAP, etc.)

Risk #6: Overly aggressive accounting practices

Risk #7: Loan loss reserves not properly calculated

Risk #8: Cybersecurity threats and data breaches

Risk #9: Poor loan underwriting processes

Risk #10: Overly aggressive business practices

RISK #1

Fraudulent Financial Reporting

What is it?

The intentional misstatement or omission of financial data to mislead stakeholders.

Examples

- Recognizing revenue prematurely.
- Deliberately underreporting expenses.

Key Indicators

- Unusual trends in financial performance.
- Missing or altered documents.
- Management reluctance to provide information.

Mitigation Strategies

- Implement a strong code of ethics.
- Conduct regular external audits.
- Enforce segregation of duties.

RISK #2

Inadequate Internal Controls

What is it?

Weak or non-existent systems to prevent fraud and errors.

Examples

- Lack of Supporting Detail, Manual Records
- Poor Segregation of Duties

Key Indicators

- Lack of oversight on transactions.
- Poorly defined roles and responsibilities.
- No monitoring of control effectiveness.

Mitigation Strategies

- Regular review and update of internal control policies.
- Training employees on compliance.

RISK #3

Insufficient Documentation and Record-Keeping

What is it?

Failure to maintain accurate, up-to-date records of financial transactions.

Examples

- Missing receipts for expenses.
- Incomplete loan application files.

Why It's a Problem

- Leads to non-compliance with audit standards.
- Makes it difficult to track financial history.

Mitigation Strategies

- Establish a centralized document management system.
- Perform periodic reviews to ensure completeness and accuracy.

RISK #4

Mismanagement of Liquidity and Cash Flow

What is it?

Inability to maintain adequate liquidity to meet obligations.

Impact

- Operational disruptions.
- Damage to reputation and member trust.

Signs of Trouble

- Over-reliance on short-term loans.
- Frequent cash flow shortages.
- Heavy reliance on wholesale funding sources.

Mitigation Strategies

- Implement cash flow forecasting tools.
- Maintain a liquidity reserve policy.

RISK #5

Non-Compliance with Regulatory Standards (NCUA, GAAP, etc.)

What is it?

Failure to adhere to legal and accounting regulations.

Potential Issues

- Penalties and fines from regulatory bodies.
- Regulatory Directives, Cease & Desist Orders

Mitigation Strategies

- Regular compliance audits.
- Assign a compliance officer to monitor adherence to rules.
- Stronger tone at the top

RISK #6

Overly Aggressive Accounting Practices

What is it?

Using accounting methods that push the boundaries of regulatory and ethical guidelines.

Consequences

- Misleading financial statements.
- Loss of stakeholder confidence.

Examples

- Overestimating asset values.
- Understating liabilities.

Mitigation Strategies

- Conduct independent reviews of financial statements.
- Train staff on ethical accounting practices.

RISK #7

Loan Loss Reserves Not Properly Calculated

What is it?

Underestimating the amount set aside for potential loan defaults.

Why It's Critical

- Understated reserves can lead to financial instability.
- Overstated profits and capital

Common Causes

- Aggressive assumptions about loan repayment, collateral values, etc.
- Failure to adjust for economic changes.

Mitigation Strategies

- Use statistical models for accurate reserve calculations.
- Review reserves quarterly to adjust as needed – Model Validation

RISK #8

Cybersecurity Threats and Data Breaches

What is it?

Risks to member data and financial systems from hacking, phishing, or malware.

Impact

- Loss of member trust.
- Regulatory fines.

Common Vulnerabilities

- Weak passwords.
- Lack of employee training.
- Outdated software systems.

Mitigation Strategies

- Conduct regular cybersecurity audits.
- Invest in modern, secure IT systems.

RISK #9

Poor Loan Underwriting Processes

What is it?

Inadequate evaluation of borrowers' ability to repay loans.

Intentional policy violations

Impact

- Increased loan defaults.
- Diminished profitability.

Indicators

- High delinquency rates.
- Inconsistent loan approval criteria.

Mitigation Strategies

- Implement automated underwriting tools.
- Train staff on consistent underwriting standards.

RISK #10

Overly Aggressive Business Practices

What is it?

Adopting High -Risk Business Strategies such as Credit risk, cash businesses, funding sources, etc.

Why it Matters

- Can result in large losses and organizational stress
- Affects compliance with KYC, difficult to staff up for this.

Mitigation Strategies

- Strong risk management tools including risk limits.
- Transparency in reporting.

What Auditors Fear The Most

What Auditors Fear the Most

The top fears of auditors:

- ➢ Lack of transparency in financial records.
- ➢ Management override of controls.
- ➢ Inability to identify related party transactions.
- ➢ Failure to detect fraud.

You should fear these as well

- ➢ They lead to material misstatements, financial restatements, and loss of trust.

A "Clean Audit" – What Does It Really Mean?

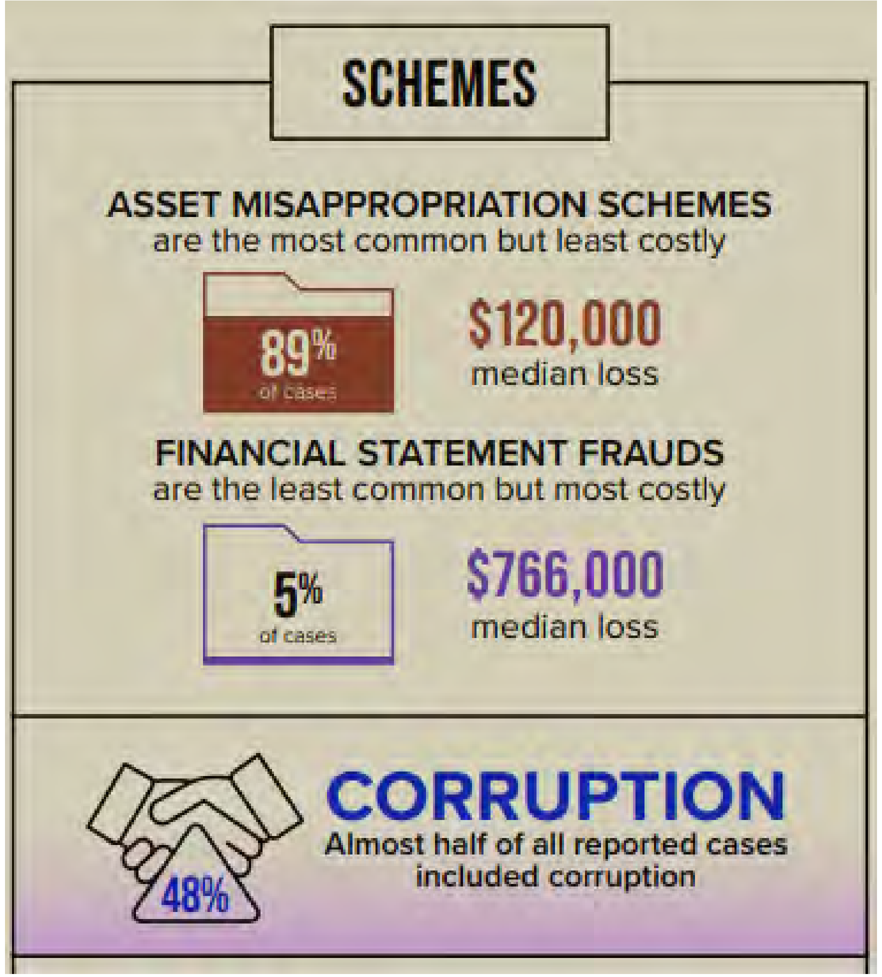
The misconception of a "clean audit":

- A clean audit doesn’t always mean the organization is in good financial health.
- It could mean that there were no audit procedures performed effectively or that key issues were overlooked.

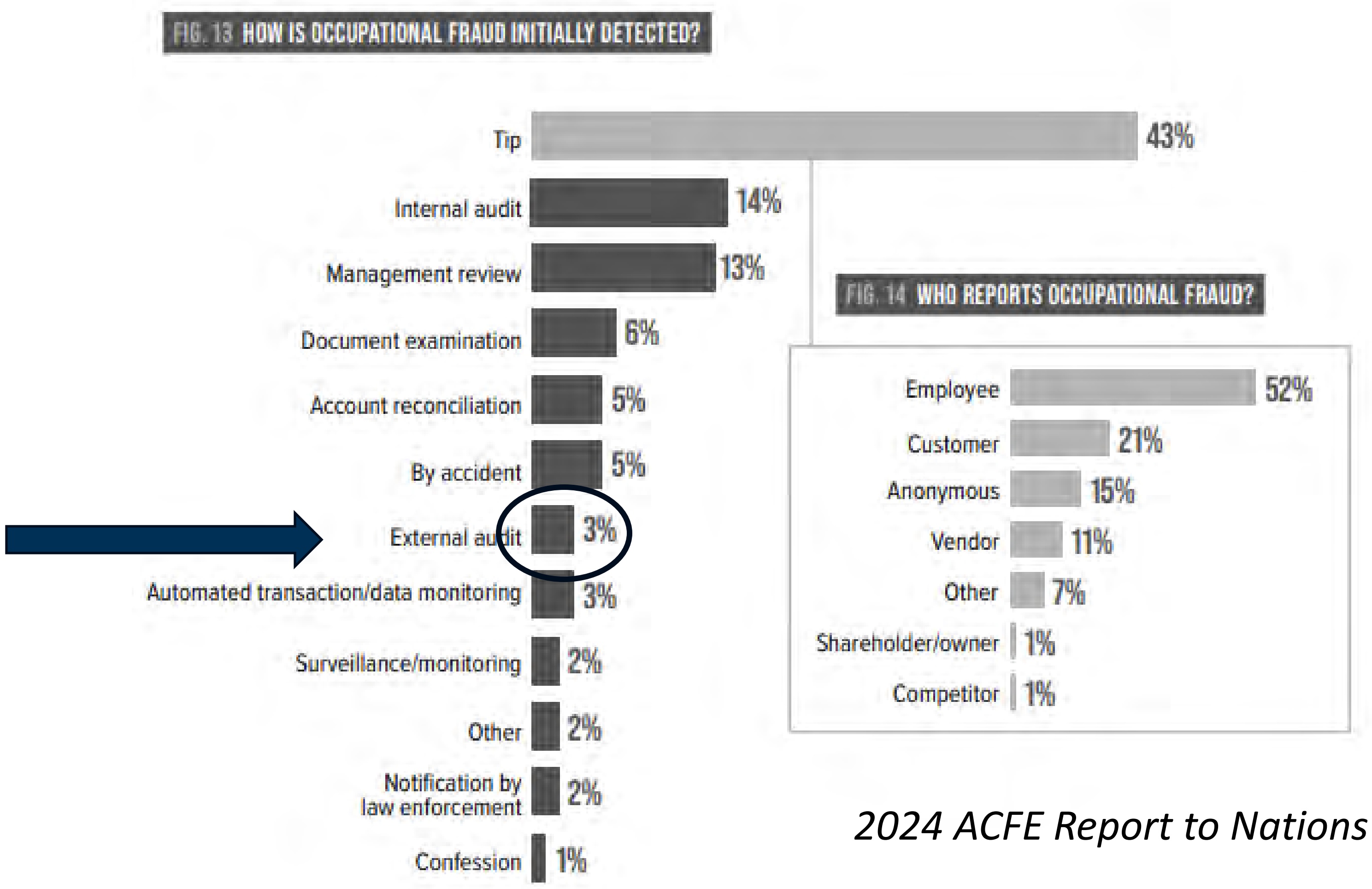
What auditors don’t say (but should):

- “Clean” could mask underlying issues such as poor internal controls or undetected fraud.

Who is Catching Fraud?

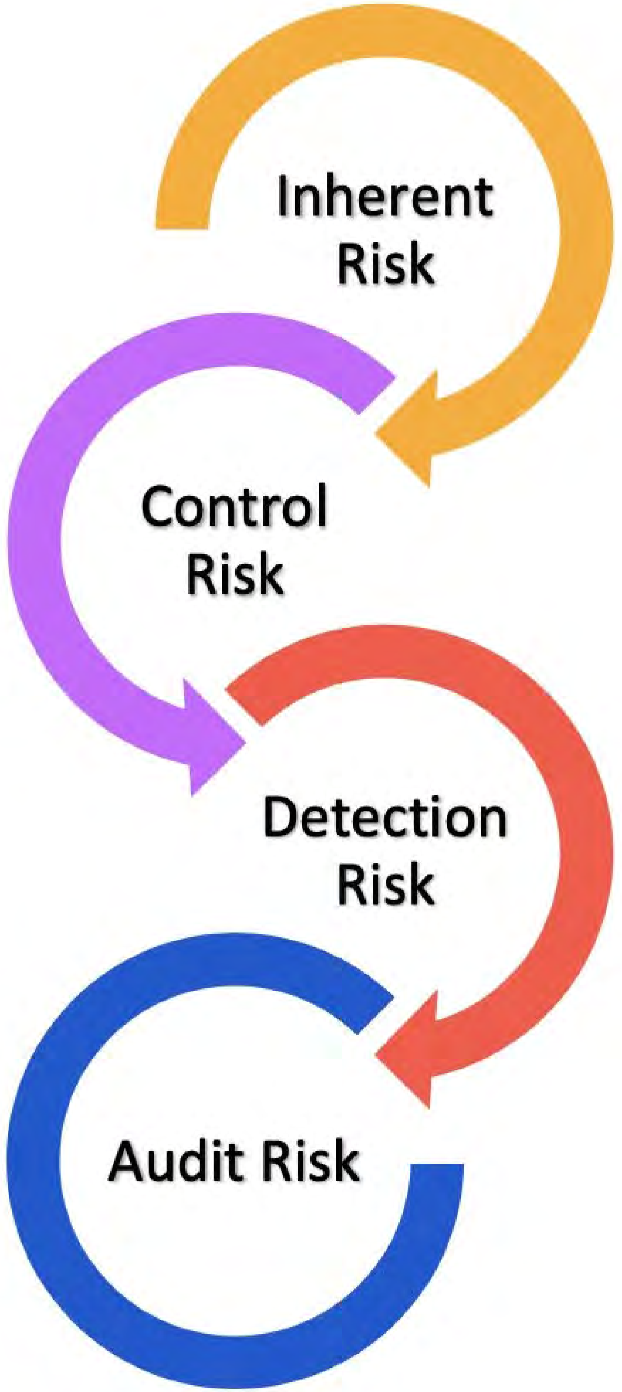


External Audit = 3% of Cases



2024 ACFE Report to Nations

Risk/Reward Paradox



Risk assessment matrix

Severity →

Likelihood	Negligible	Minor	Moderate	Significant	Severe
Very Likely	Low Med	Medium	Med Hi	High	High
Likely	Low	Low Med	Medium	Med Hi	High
Possible	Low	Low Med	Medium	Med Hi	Med Hi
Unlikely	Low	Low Med	Low Med	Medium	Med Hi
Very Unlikely	Low	Low	Low Med	Medium	Medium

Risk Matrix Example

Likelihood X Severity = Risk Level

“Materiality” Concepts In Financial Statement Auditing

What is Materiality?

Significance of an amount, transaction, or discrepancy in financial statements.

- Omission of an Item
- An Error in an Item

Can Influence The Decisions of Those Who Rely on the Financial Statements.

What is Material?

“Misstatements, including omissions, are considered to be material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment <u>made by a reasonable user</u> based on the financial statements”.

What is a Reasonable User?

- Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence.
- Understand that financial statements are prepared, presented, and audited to levels of materiality.
- Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment, and the consideration of future events.
- Make reasonable judgments based on the information in the financial statements.

Sample “Materiality” In Financial Statement Auditing

Table A.—Net Worth Classification of Non-“New” FICUs

Net worth category	Net worth ratio	# of non-“new” FICUs	Percent of all non-“new” FICUs
"Well Capitalized"	7% or greater	9634	96.96%
"Adequately Capitalized"	6% to 6.99%	210	2.11%
"Undercapitalized"	4% to 5.99%	53	0.53%
"Significantly Undercapitalized"	2% to 3.99%	23	0.24%
"Critically Undercapitalized"	Less than 2%	15	0.15%

Prompt Corrective Action (PCA) Net Worth Regulations Under 12 CFR Part 702

Sample "Materiality" In Financial Statement Auditing

AFI-CX-2: Financial Statement Materiality Worksheet for Planning Purposes

Table 2—Other Benchmarks and Illustrative Percentages	
Benchmark	**Illustrative Percentage**
Total revenue	0.5%-2.0%
Total assets	0.5%-2.0%
Gross profit	1.0%-2.0%
Pretax income	5.0%-10.0%
Equity	3.0%-5.0%
Cash flows from operations	3.0%-5.0%

2. **Planning Materiality.** (Complete a. and b.)

a. BENCHMARK and AMOUNT (Select the benchmark you wish to use.)

- ○ Total Revenue (Annualize if interim amount is used.)
- ◉ Total Assets — $1,000,000,000
- ○ Other Benchmark (specify)

b. PLANNING MATERIALITY CALCULATION (**Note:** If an Other Benchmark amount is used, a suitable percentage should be manually entered.)

Base Amount from Table 1 +	(Percentage from Table or Suitable Percentage from Chosen Benchmark	x Benchmark Amount)	= Planning Materiality
$610,000	0.45%	$1,000,000,000	$5,100,000

Sample "Materiality" In Financial Statement Auditing

	December 31, 2024	
	Amount	Ratio
Amount needed to be classified as "Adequately capitalized"	$ 60,000,000	6.0%
Amount needed to be classified as "Well capitalized"	$ 70,000,000	7.0%
Actual PCA net worth	$ 95,000,000	9.5%
Total Assets	$ 1,000,000,000	

Prompt Corrective Action (PCA) Net Worth Regulations Under 12 CFR Part 702

Sample “Materiality” In Financial Statement Auditing

	December 31, 2024	
	Amount	**Ratio**
Amount needed to be classified as “Adequately capitalized”	$ 60,000,000	6.0%
Amount needed to be classified as “Well capitalized”	$ 70,000,000	7.0%
Actual PCA net worth	$ 59,900,000	5.99%
Total Assets	$ 1,000,000,000	

Prompt Corrective Action (PCA) Net Worth Regulations Under 12 CFR Part 702

Sneaky Ways Management Can "Cook the Books“ to *Less than a Material Amount* …

Improper revenue recognition :

Recording income before it's earned.

Overstating assets :

Inflating the value of assets to improve financial appearance.

Off-balance-sheet financing :

Hiding liabilities or obligations off the books.

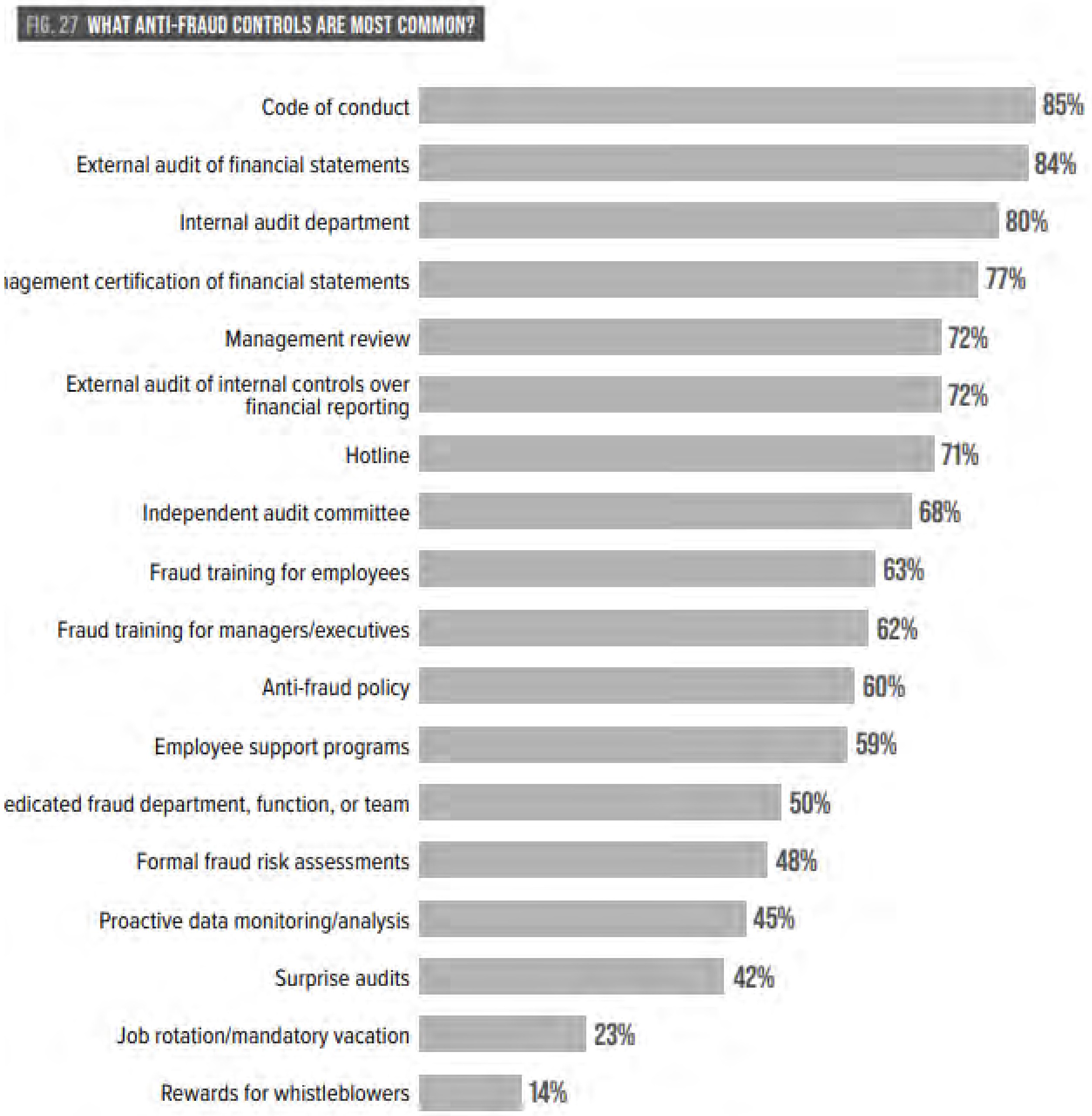
Reserving or deferring expenses :

Timing expenses to make the financials look better in the short term.

Cooking the Books

SCHEMES					
Category	**Cases**	**25th percentile**	**Median (50th percentile)**	**75th percentile**	**Mean***
Asset misappropriation	1,309	$22,000	$120,000	$500,000	$1,116,000
Noncash	246	$10,000	$66,000	$250,000	$537,000
Billing	207	$25,000	$100,000	$448,000	$624,000
Cash on hand	143	$10,000	$50,000	$200,000	$357,000
Skimming	130	$10,000	$43,000	$200,000	$205,000
Expense reimbursements	127	$5,000	$50,000	$150,000	$251,000
Check and payment tampering	109	$26,000	$155,000	$510,000	$787,000
Cash larceny	95	$10,000	$50,000	$300,000	$561,000
Payroll	74	$10,000	$50,000	$250,000	$383,000
Register disbursements	21	$4,000	$50,000	$94,000	$95,000
Corruption	662	$50,000	$200,000	$1,000,000	$2,738,000
Financial statement fraud	61	$100,000	$766,000	$4,815,000	$6,045,000

Anti - Fraud Controls



CPA Management Letters

Just Words? *OR* Deeper Meaning

CPA <u>*Management*</u> Letters

“Material Weakness” in Internal Control

A deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a <u>material</u> misstatement of the entity’s financial statement will not be prevented or detected and corrected on a timely basis

CPA *Management* Letters

“Significant Deficiencies” in Internal Control

A deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance

CPA *Management* Letters

“Other Matters”

A deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

CPA *Recommendations*

Recommendations

It is the responsibility of management and those charged with governance to analyze the recommendation and determine if it is feasible to implement them, if another internal control could accomplish the same result at a lower cost, or if nothing should be changed and they are willing to accept the risk

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Governance Letter

(SAS 114)

Addressed to:

Board of Directors *and* Supervisory Committee

Access & Exchange of Information

AU Section 380.17

Ensures the auditor has access to the audit committee, as necessary.

- The chair of the audit committee and, when relevant, the other members of the audit committee, meet with the auditor periodically.
- The audit committee meets with the auditor without management present at least annually.

Governance Letter Content

Communicate Audit Adjustments

Audit Scope & Responsibilities

Other Significant Matters

REQUIRED COMMUNICATIONS

- Auditors' Responsibility under U.S. Audit Standards
- Significant Accounting Policies
- Judgments about the Quality of the Credit Union's Accounting Principles
- Significant Adjustment and Unadjusted Differences <u>Considered by Management to be Immaterial</u>
- Sensitive Accounting Estimates
- The Adoption of, or a Change in, an Accounting Principle
- Disagreements with Management on Financial and Reporting Matters
- Difficulties Encountered in Performing the Audit
- Consultation with Other Accountants
- Independence Standards

ACCOUNTING POLICIES, JUDGEMENTS
&
ESTIMATES

Significant Accounts and Disclosures

- Allowance for Loan Losses
- Deferred Compensation Liability
- Fair Value of Investments Available-for-Sale

ACCOUNTING POLICIES, *JUDGEMENTS & ESTIMATES*

During our audit we evaluated the critical accounting policies, the judgements, and we assessed the estimates made by management. We evaluated the nature of the position as it relates to the alternative methods available and standard industry practice. The following is our assessment of the Credit Union's methods:

Evaluation As of December 31, 2024						
	Overly Conservative	***More Conservative***	***Moderate***	***Less Conservative***	***Overly Aggressive***	***Evaluation Consistent with our Assessment 2023?***
Allowance for Loan Loss		x				Yes
Deferred Compensation Liability			x			**Yes**
Fair Values of Investments Available for Sale			x			**Yes**

ACCOUNTING POLICIES, *JUDGEMENTS & ESTIMATES*

Range within GAAP Alternatives and Subjective Input				
Overly Conservative	**More Conservative**	**Moderate**	**Less Conservative**	**Overly Aggressive**
Accounting treatment biased toward risk of understating net assets and/or net income.	Accounting treatment may have a tendency to decrease net assets and/or net income relative to moderate treatment.	Accounting treatment in middle of acceptance range.	Accounting treatment may have a tendency to increase net assets and/or net income relative to moderate treatment.	Accounting treatment biased toward risk of overstating net assets and/or net income.

SUMMARY OF ADJUSTMENTS

We accumulated all factual and judgmental misstatements identified during the audit (other than those that are trivial) and communicate them to the appropriate level of management.

We identified ***ONE ADJUSTMENT*** to the financial statements:

-Grant Receivable in the amount of $1,826,265 (increase to assets and increase to liabilities).

STATEMENT OF FINANCIAL CONDITION

(PAGE 3)

ASSETS

	2021	2020
Cash and due from banks	$ 75,099,841	$ 25,271,123
Interest-bearing deposits	2,764,709	769,340
Cash and cash equivalents	77,864,550	26,040,463
Investments		
Available-for-sale, at fair value	188,646,528	210,922,048
Held-to-maturity, at amortized cost	63,641,673	38,964,749
Other investments	1,759,703	3,027,797
Loans to members, net of the allowance for loan losses of $1,223,248 and $1,098,928 for 2021 and 2020	190,860,755	157,385,639
Premises and equipment, net	10,163,585	10,861,704
National Credit Union Share Insurance Fund Deposit	4,247,565	3,469,862
Cash surrender value of life insurance	4,954,903	4,480,388
Other assets	2,342,240	3,750,941
Grant receivable	1,826,265	-
Total assets	$ 546,307,767	$ 458,903,591
LIABILITIES AND MEMBERS' EQUITY		
Liabilities		
Members' shares	$ 487,435,823	$ 406,133,118
Deferred grant revenue	1,826,265	-
Accrued expenses and other liabilities	2,862,853	2,202,363
Total liabilities	492,124,941	408,335,481
Members' equity, substantially restricted		
Regular reserve	1,970,996	1,970,996
Undivided earnings	49,947,998	48,083,120
Accumulated other comprehensive income	2,263,832	513,994
Total members' equity	54,182,826	50,568,110
Total liabilities and members' equity	$ 546,307,767	$ 458,903,591

SUMMARY OF:

UNADJUSTED DIFFERENCES

We identified ***TWO UNADJUSTED DIFFERENCE*** falling below our threshold of materiality and not requiring adjustment (amounts are approximate):

- Advanced premium amortization $335,000 (offset with the cumulative effect of the prior year unadjusted difference of $312,000)
- Allowance for loan loss overstatement of $416,173

The Importance of Post -Audit Follow-Up Steps

Why follow -up is critical:

- **Implement recommendations:**
  Ensure that audit findings are addressed.
- **Monitor progress:**
  Set a timeline for resolving issues and improving practices.
- **Evaluate effectiveness:**
  Are the improvements actually solving the problems?
- **Prevent the recurrence of issues:**
  Develop ongoing monitoring and accountability systems.

Case Study: Example of Audit Oversight

Case Study:
Unauthorized Wage Payments

Segregation of Incompatible Duties

- Payments to fake employees
  - False employees
  - False wage amounts
- Should have
  - restricted access to payroll records, and
  - Handing out the pay cards.
  - Routine reconciliations

Case Study:
Fictitious Loans

Segregation of Incompatible Duties

- Loans advanced to phony bowers
  - False member accounts established
  - False loan applications processed and approved
  - Loans were funded.
- Should have
  - Restricted who can fund loans, and
  - Conducted OFAC check on false members
  - Routine reconciliations

Case Study:
Out of Policy Loan Approvals

Ineffective Management Reporting

- Loans made to members at terms outside of approved board policy.
  - 40% of loans approved outside of policy.
  - Higher loan charge offs than expected.
  - Loans were funded and approved.
- Should have
  - Restricted who could approve exceptions.
  - Reported policy exceptions to the Board
  - Re-written the loan policy

Best Practices for Effective Audits

What you can do to ensure a thorough and beneficial audit:

- **Collaborate with auditors**
  Provide full access to documents and staff.
- **Encourage transparency**
  Create an environment where all issues are disclosed.
- **Plan for future audits**
  Make improvements year-over-year.

EXTERNAL AUDIT *VS.* INTERNAL AUDIT

External Audit

- Tests Financial Statement Accuracy and Acctg. Records
- Objective is focused on financial statements.
- Must be a 3rd Party CPA
- Scope is GAAP & GAAS based.
- Reports to the Sup. Committee, Board and those Charged with Governance.
- Users include Members, Regulators, and Those Charged with Governance

Internal Audit

- Focused on operations, internal control procedures and compliance.
- Objective is to review routine process and activities.
- Internal employees (or outsourced contractors).
- Scope is Directed by Management. Often excludes key Risk Areas.
- Reports to Management and sometimes the Supervisory Committee.
- Users are primarily Management/Not all reports go to SC.

EXTERNAL AUDIT *VS.* INTERNAL AUDIT

External Audit

- Most highly trained auditors/Rigorous Standards and Licensing.
- Guided by Materiality.
- Only catches Fraud 3% of the Time.
- Deep understanding of risk.
- Focused on efficiency/Results (competitive)
- Work stands up to 3rd party scrutiny

Internal Audit

- Auditors may not be fully trained – Skill gap.
- Lack management support.
- Focused on control steps or procedures (minutiae).
- Informal Reporting and Documentation
- Might not fully take risk into account.
- Can be prone to "empire building"
- Return on investment is not measured.

Conclusion

Understand audit and mitigate risks.

Be wary of the "clean audit" myth.

Ensure follow-up on audit recommendations for lasting improvements.

Questions?

Thank You!

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