

# Identifying Observations as an Internal Auditor



PRESENTED BY: CHAD GARBER, CPA | PARTNER  
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# INTRODUCTIONS



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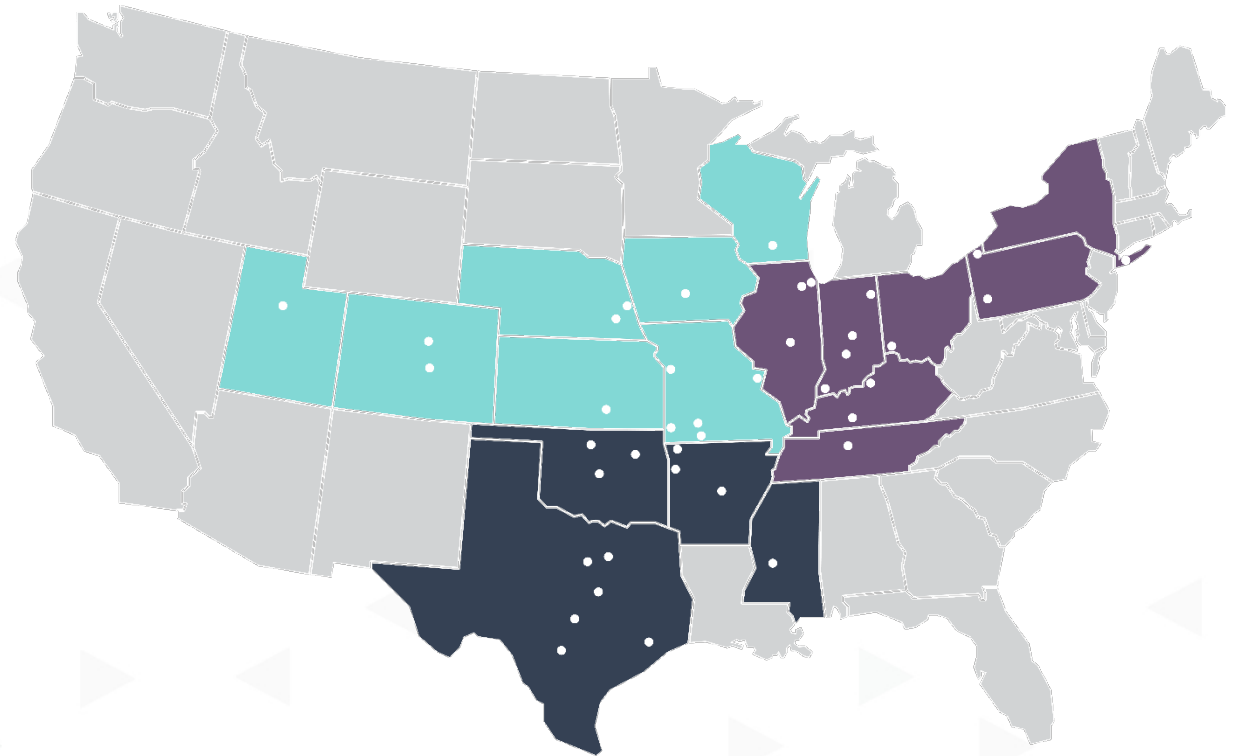


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Director  
Indianapolis, Indiana

# BKD CPAS & ADVISORS



- Founded in 1923 – Baird, Kurtz & Dobson
- 40 offices in 18 states
  - Stretch from Utah to New York
- Headquarters: Springfield, MO
- Engagements in all 50 states



# OVERVIEW



- 1 Discuss key differences between an observation & a finding
  - Why observations are important to the overall audit process
  - Group discussion – common observations
- 2 Discuss tips for identifying observations within the scope of internal audit
- 3 Discuss observations identified outside of an internal audit
  - Tips for identifying observations outside the scope of internal audit
  - Hot topics & NCUA primary focus for 2019



# OBSERVATION VS. A FINDING

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# COMMON CHARACTERISTICS OF A FINDING

- A matter having a direct negative impact on internal control
- Noncompliance with internal policy, procedures or applicable laws & regulations
- Often has a negative connotation
- Gets assigned a risk rating



# BKD RATINGS OF INTERNAL AUDIT FINDINGS

- **Critical** – Indicates a significant matter requiring immediate attention & involvement by the supervisory committee & senior management
- **High** – Indicates a significant matter requiring immediate attention by senior management & possibly the supervisory committee
- **Moderate** – Indicates a matter to be given priority by management &, if not immediately addressed, may significantly impair the control structure or operating effectiveness of the internal control systems
- **Low** – Indicates a matter to be addressed in the normal course of business, which may be of sufficient importance to be brought to management's & supervisory committee's attention

# COMMON CHARACTERISTICS OF AN OBSERVATION

- Opportunity to enhance efficiencies of operations
- Best practices within the industry
- Add value to the credit union
- No risk rating
- Often has a positive connotation



# WHY OBSERVATIONS?

- Outside of adding value to the credit union, identifying observations allows you to
  - Build trust with management & the auditee
  - Increase your credibility
  - Eliminate or reduce the “policeman” or “I got you” mentality

# COMMON OBSERVATIONS IDENTIFIED DURING AN INTERNAL AUDIT

- Policy enhancements or lack of policies
- Incomplete or inadequate written procedures
- Inadequate documentation
- Inconsistencies in application of procedures
- Inadequate segregation of duties
- Lack of fraud or whistleblower hotline
- Inadequate tracking of findings



# FRAUD HOTLINE

## Association of Certified Fraud Examiners (ACFE) Fraud Statistics:

- 40% of fraud is detected by tips, according to ACFE
- 5% of revenues are lost each year due to fraud
- 16 months pass before the average fraud is detected
- Organizations with hotlines catch fraud 50% faster



# EXAMPLE ROLLING FINDINGS REPORT

**Sample Institution  
Rolling Findings Report  
Open Items**

#	Priority	Source	Finding	Management Response	Date of Finding	Responsible Party	Due Date	Status
20xx-01	High	External Audit						
20xx-02	Moderate	Internal Audit						
20xx-03	Low	Regulator						

# GROUP DISCUSSION

- In groups of 2-3 people, discuss some observations you've identified during an internal audit. Be prepared to discuss one with the group.

# GROUP EXERCISE

- In groups of 2-3 people, using the handout provided, classify each item either as a finding or an observation.



# TIPS FOR IDENTIFYING OBSERVATIONS DURING AN INTERNAL AUDIT

2

# PLANNING MEETING

- Hold a planning meeting prior to testing with management & auditees
- Great time to identify areas of opportunity
- Ask if there are any specific concerns

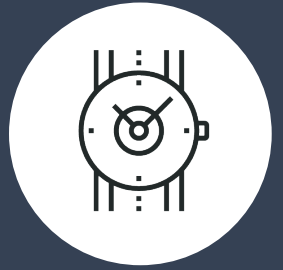


# PLANNING MEETING AGENDA TOPICS



- Anticipated scope
- Significant changes in controls, policies or procedures
- New technology
- Staff turnover
- New products
- Prior findings or observations
- Regulatory exam concerns
- External audit findings/deficiencies
- Timeline – see example

# EXAMPLE TIMELINE



Process/Activity	Initial Scope Meeting	Draft of procedures provided	Assistance List Provided	Fieldwork Dates	Exit Meeting	Draft Report	Mgmt. Response Submit'd	Final Report	Reports Needed	Supervisory Committee meeting date
<i>Suggested Timeline</i>	<i>Week beginning 6 weeks prior to fldwk</i>	<i>Week beginning 4 weeks prior to fldwk</i>	<i>Week beginning 4 weeks prior to fldwk</i>	<i>For the week beginning</i>	<i>1 week after last day of fldwk</i>	<i>2 weeks after last day of fldwk</i>	<i>4 weeks after last day of fldwk</i>	<i>6 weeks after last day of fldwk</i>	<i>1 week prior to meeting date</i>	<i>TBD</i>
Risk Assessment	n/a	n/a	n/a	n/a	n/a					
<i>Actual</i>										
Visit #1										
<i>Actual</i>										
Visit #2										
<i>Actual</i>										
Visit #3										
<i>Actual</i>										
Visit #4										
<i>Actual</i>										

# WALK-THROUGHS, QUESTIONNAIRES & INTERVIEWS

- Great way to gain an understanding of the process & related controls
- Helps to understand where potential misstatements or noncompliance with policies & procedures may occur
- Able to assess the competency of the person performing the control
- More easily able to identify opportunities for improvement



# EXIT MEETING

- Discuss open items, questions, etc.
- Discuss findings & observations with management & auditee
- Achieve consensus & reach an agreement on findings vs. observations



# POST INTERNAL AUDIT SURVEY



First-hand feedback from auditees,  
management &/or the supervisory committee

# COMMUNICATING OBSERVATIONS

- Know your audience
- Can be communicated orally or written
- Clearly state the facts & circumstances
- Provide suggestions or recommendations
- Allow for auditee to provide responses
- Establish a due date





# IDENTIFYING OBSERVATIONS OUTSIDE OF THE SCOPE OF AN INTERNAL AUDIT

3

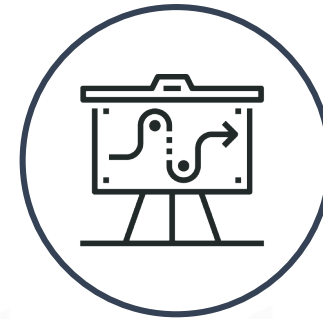
# COMMON TYPES OF OBSERVATIONS IDENTIFIED OUTSIDE OF AN INTERNAL AUDIT

- Industry best practices
- Overall industry trends
- Emerging risks
- Examiner & auditor hot buttons, hot topics, etc.



# HOW DO YOU GO ABOUT FINDING OBSERVATIONS OUTSIDE OF THE SCOPE OF AN INTERNAL AUDIT?

- Networking
- Industry publications
- NCUA letters to credit unions
- External auditors



# NETWORKING

- Attend conferences
  - National conferences
  - State conferences
  - League conferences
- Core system user group
- Chapter meetings
- Roundtables

# NCUA LETTERS TO CREDIT UNIONS & OTHER GUIDANCE



- Letters to credit unions
- Letters to federal credit unions
- Risk alerts
- Regulatory alerts
- Supervisory letters
- Accounting bulletins
- Consumer Financial Protection updates
  - [https://www.ncua.gov/regulation-supervision/letters-credit-unions-other-guidance?exttype=letter\\_to\\_credit\\_union#results](https://www.ncua.gov/regulation-supervision/letters-credit-unions-other-guidance?exttype=letter_to_credit_union#results)

# NCUA LETTERS TO CREDIT UNIONS & OTHER GUIDANCE



You can search these regulatory letters going back to 1979 by document type, the year issued, by subject and by title or keywords. Please note that obsolete letters are not included.

## Search

Search keywords only

## Filters

Title   Select All Title

Showing 1 - 10 of 396 Results

Type

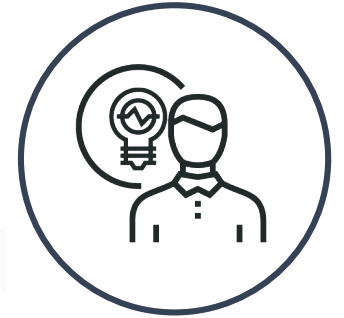
Subject

Year

Docket #	Title	Subject	Type	Year
19-CU-01	<a href="#">Supervisory Priorities for 2019</a>	Examination Program	Letters to Credit Unions	2019
18-CU-03	<a href="#">Merger Rule Provisions Including the Member-to-Member (MTM) Communications Process</a>	Mergers	Letters to Credit Unions	2018
18-CU-02	<a href="#">Examination Guidance for Bank Secrecy Act Customer Due Diligence and Beneficial Ownership Compliance</a>	BSA/AML	Letters to Credit Unions	2018

# INDUSTRY PUBLICATIONS

- **The Audit Report** (monthly magazine published by ACUIA)
- **Credit Union Times**
- **Credit Union Journal**
- **Journal of Accountancy**
- Webinars
- Whitepapers



# ASK YOUR EXTERNAL AUDITOR!

- Your external auditor is a great resource for identifying observations
  - Access to numerous exams
  - Significant amount of experience in control testing
  - Work on a number of credit unions varying in size & complexity
  - Aware of upcoming accounting standards & the impact to your credit union



# HOT TOPICS & NCUA PRIMARY FOCUS FOR 2019

- Credit Risk – Commercial Business Lending
- Current Expected Credit Losses
- Bank Secrecy Act Compliance
- Asset Liability & Interest Rate Risk Management
- Consumer Compliance
- Mergers & Acquisitions
- Other Upcoming Accounting Standards



# CREDIT RISK – COMMERCIAL/MEMBER BUSINESS LENDING (MBL)

- Expand Internal Audit Risk Assessment & Audit Plan to include MBL
- Inappropriate methods are being used for calculating impairment under ASC 310
  - Fair value of collateral (only if deemed collateral dependent)
  - Present value of expected cashflows (only if not deemed collateral dependent)
- Periodic loan review process
  - Required to review the financial condition of a borrower on a periodic basis
  - Update risk rating accordingly



# CREDIT RISK – MBL

- Policy enhancements
  - List qualifications & experience requirements for all personnel in commercial lending
  - Include appraiser requirements (including independence standards)
  - Loan rating system – include quantitative analysis of credit risks that are consistent with the risk characteristics of your MBL portfolio
    - Refer to NCUA Rules & Regulations Part 723.3, 723.4 & 723.6 for more information
- Policy exception tracking & reporting
  - Enhance reporting by aggregating the exceptions with the performance of the loans

# CURRENT EXPECTED CREDIT LOSSES (CECL)



- Expectation is that examiners will start asking where your credit union is in the process
  - Consider using this CECL readiness checklist to assess progress
    - <https://www.csbs.org/cecl-readiness-tool>



CECL readiness  
assessment

- BKD CECL Implementation Benchmark Survey – see handout
- Refer to NCUA Letter to Credit Union 17-CU-05 & 16-CU-13 for more information
- Stop & Study Bill
  - Would require examiners to study CECL's impact & delay the effective date by one year

# BSA COMPLIANCE



- Continued focus area of the examiners in 2019
- Compliance with new beneficial ownership regulation (31 CFR 1010.230)
- Resolution of false positive suspicious activity
- See NCUA Letter to Credit Union 18-CU-02 for more information about the NCUA's primary focus surrounding BSA

# CONSUMER COMPLIANCE

- Will evaluate federal credit union's compliance with HMDA reporting
  - Refer to the Consumer Financial Protection Update 18-01 for more information
- Military Lending Act (MLA)
  - Refer to the NCUA Regulatory Alerts 16-RA-04 for more information

# MERGER & ACQUISITION ACTIVITY

- Since Q1 2018, there has been a significant increase in M&A in the credit union space



- What controls does the credit union have in place?
  - Controls surrounding due diligence, Day 1, Day 2, system integration, etc.
  - Great area to identify observations & add value to the CU

# OTHER UPCOMING ACCOUNTING STANDARDS



The following standards will be applicable within the next two years:

- Revenue Recognition (Topic 606) – effective for year-ends beginning after December 15, 2018
- Leasing – (Topic 842) – effective for year-ends beginning after December 15, 2019

# Questions?

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# Thank You!

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