Chapter 27

SHORTAGES

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APPENDIX 27A – Warning Signals 27A-1

Chapter 27

SHORTAGES

Examination Objectives

- Determine whether a shortage exists in the credit union
- Determine whether the credit union has take appropriate action to identify the shortage, notify surety, and to correct underlying problems that caused the shortage

Associated Risks

- Reputation Risk – includes the risk that management did not establish adequate internal controls to detect or deter shortages, resulting in poor publicity or administrative action;
- Liquidity Risk – includes the risk that adequate liquidity is not available due to reliance on inaccurate financial reports; and
- Transaction Risk – includes the risk that financial reports are not accurate due to manipulation of financial transactions.

Overview

A shortage is any loss of funds or property belonging to a federally insured credit union caused by dishonesty such as embezzlement, robbery, burglary, kiting, mysterious disappearance, and larceny.

NCUA provides guidance to all federally insured credit unions that discover a shortage. However, credit union officials must take ultimate responsibility for providing adequate internal controls, detecting shortages, and taking appropriate action when they discover shortages.

Examiner's Role

Examiners should not approach every examination believing a shortage exists or that employees or officials are dishonest. However, if examiners suspect a shortage, they should determine whether one exists. Audit procedures are not a normal part of the examination process and are beyond the scope of this Guide; therefore, examiners may find it necessary to perform certain audit steps to determine whether shortages are occurring.

Credit union officials, the regional office, the examination process, or some other source may alert examiners to a possible shortage. The

procedures described in this and other chapters will assist the examiner in determining whether a shortage exists, the extent of the shortage, and the necessity of further action, such as an audit. Follow-up on shortages is part of district management.

Examiners should be cautious about what they say regarding possible shortages. Before confronting an individual suspected of a shortage, informing credit union officials of a suspected shortage, or taking any action regarding the removal or suspension of any employee or official, the examiner should contact the supervisory examiner. Upon discovering a shortage, the examiner should suggest that officials mail the Suspicious Activities Report (SAR) to the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN), and notify surety. Many types of shortages also require the officials to notify the local police authority and the Federal Bureau of Investigation (FBI).

Examination Scope

If the examiner discovers or learns of an internal shortage, the examiner should expand the examination as necessary to determine the facts surrounding the alleged embezzlement. After discovering and documenting the pattern, the supervisory committee must investigate and resolve the shortage.

The examiner should document in the report any material shortage and actions taken by management to resolve the shortage.

Notifying Credit Union Officials

As soon as examiners determine with reasonable certainty that a shortage exists, they should discuss the matter with the supervisory examiner. After concurrence from the supervisory examiner, the examiner should contact the board chairperson and arrange for a board meeting. The directors should invite members of the supervisory and credit committees. The examiner should consider inviting the supervisory examiner or another available examiner to attend and witness this meeting. At that meeting:

- The examiner should present directors with evidence that indicates the shortage. The board may give the person allegedly responsible the opportunity to be heard.

- The examiner should discuss the surety bond provisions, the filing of a bond claim, and should encourage the officials to contact surety in a timely manner.

- If proven, the board should suspend or terminate the official or employee responsible for the embezzlement. Ultimately, it is the board's responsibility to take appropriate action. The examiner's goal is to ensure that the person responsible no longer has the ability to cause losses or destroy credit union records. However, examiners should not act before contacting the supervisory examiner for concurrence.

- The officials usually will suspend or terminate an alleged embezzler during the meeting, and should contact surety in a timely manner. The person responsible may volunteer to resign before the board meeting.

- If an embezzler makes full restitution, the directors might fail to take action against the alleged embezzler. The examiner should explain the board's fiduciary responsibility to the members and point out that failure to act may result in release of surety from liability for any future shortages. In addition, the directors may be personally liable for losses sustained because of their failure to act.

- The examiner should make certain that the officials clearly understand their responsibilities to update records and to perform (or cause to be performed) an audit. In some cases, they should explore using a qualified fraud audit firm.

- Under most surety bond policies, credit unions have an obligation to mitigate damages by taking reasonable steps to reduce their loss. If the perpetrator offers restitution, officials should contact legal counsel and surety for an opinion and concurrence before acceptance. Officials should be skeptical of accepting any restitution other than cash. If the perpetrator offers a check, the officials may accept it subject to collection. Any receipt given should only acknowledge the amount and manner of payment and should not allege to be "payment in full." If the directors accept restitution, the minutes should document the acceptance. If the

question arises, the examiner should encourage the directors not to change the credit union's surety during presentation of the claim.

- The examiner should caution the officials against agreeing, in writing or orally, not to prosecute the responsible person in consideration of repayment or promise of repayment. The officials should not release the credit union's claim against the responsible person without legal counsel's advice.

- The examiner should inform the directors about the harm that publicity regarding a shortage often does to a credit union and advise them to avoid it if possible. Conversely, rumors sometimes do more harm to member confidence than the actual facts. When information about a shortage becomes publicly known, the directors may call a special meeting of the members and present the facts concerning the shortage. In most instances, however, such a meeting is not necessary or desirable.

- Other matters the examiner should consider discussing with the board include (1) reviewing the alleged embezzler's loan and share accounts, (2) changing combinations or locks, (3) changing access and passwords to all electronic systems, (4) changing signatures at banks or other institutions, (5) revoking investment redemption authority, (6) stopping payment on checks that contain known forgeries, and (7) pinpointing the responsibility of the person designated to maintain the records.

Notifying Surety

It is the officials' responsibility to send notice of loss to surety. If the credit union officials refuse to notify surety, the examiner should discuss the refusal with the supervisory examiner. The examiner should inform the credit union officials that their failure to file a notice of loss could result in loss of the bond claim and, therefore, breach their fiduciary duties. The credit union should request Proof of Loss forms from the surety bond company.

The exact amount of the shortage need not be known before giving notice of loss to surety. (A delay until the officials know the specific amount could jeopardize recovery of the claim from the surety company.) The examiner should review pertinent provisions of the

surety bond and refer to the Bond Coverage section of this Guide before advising officials or sending the notice of loss to surety.

The surety bonds currently in use in credit unions differ in respect to the notice of loss provisions, so it is very important to review the credit union's surety bond. Officials must provide notice to surety within a specified number of days of discovery (as specified in the bond notification requirements.) When the claim is significant in relation to credit union reserves, credit unions should consider seeking legal assistance from an attorney familiar with surety bond law.

Examiners should review prior bonds in effect during the period of the shortage to determine if the officials should provide notice to more than one surety company. If credit union files do not contain complete copies of the bonds, officials should contact surety bond companies and request a copy.

Once the auditor has completed the audit and verification, officials should submit a proof of claim to surety within the time limits specified. Please refer to the Bond Coverage chapter for additional guidance.

Notifying the U.S. Department of Treasury (FinCEN)

The FBI investigates and the local US Attorney prosecutes cases involving violations of federal criminal statutes. As set forth in §748.1 of the *NCUA Rules and Regulations*, the officials must complete the SAR and mail the report to FinCEN.

In cases of criminal activity, the officials notify the FinCEN by completing and submitting a SAR, which includes the instruction for completion. (If the officials indicate reluctance to completing the form, the examiner should discuss with the supervisory examiner whether or not the examiner should notify FinCEN.)

Establishing Accounts Receivable

The credit union may establish an account receivable in accordance with generally accepted accounting principles, taking care not to unreasonably anticipate a recovery. If properly established, the account remains on the credit union's records until surety pays the claim, or recovery is a reasonable certainty.

Contacts with the Press

After learning of a possible shortage, the press may contact the credit union or examiner for information. Examiners should point out to reporters that they may not release any information and that the credit union's officials are the proper source of information. In rare instances, the examiner may refer a persistent reporter to the regional office. Where significant shortages exist or when obvious criminal activity occurs, the credit union should develop a plan for dealing with the press that includes appointing a single credit union spokesman.

Unrecorded Shares

The potential exists for unrecorded shares in a credit union, which can cause losses to the National Credit Union Share Insurance Fund (NCUSIF.) The following steps may assist in revealing unrecorded shares:

- Review adequacy of verification of member accounts;
- Review internal controls over printing and mailing of statements;
- Review supervisory override reports for management overrides of cash transactions;
- Review volume of transactions in credit union's checking account. A high volume of transactions during the month may warrant further review; and
- Review supervisory committee's or head teller's role in performing surprise cash accounts.

Embezzlements

The term embezzlement, defined as acts by officials or employees for the purpose of diverting funds for their own or a third party's benefit, includes all internal shortages. Appendix 27A contains a list of "Warning Signals" that might indicate a shortage.

Some of the most common embezzlements include:

- Fictitious or unauthorized loans;
- Unreported loans to employees and family members;
- Unrecorded shares;

- Theft of member shares (especially dormant or inactive accounts);
- Overdrawn accounts;
- Theft of insurance proceeds;
- Theft of receipts by collection agencies;
- Theft through unauthorized expenses;
- Misappropriation of travelers checks or money orders;
- Theft of closed accounts;
- Misappropriation of loans from other credit unions;
- Misappropriation of credit union checks;
- Misappropriation of deposits in transit;
- Misappropriation by manipulating payroll deductions;
- Misappropriation through the information processing system;
- Misappropriation of credit union investments;
- Computer crime;
- Repossessed collateral; and
- Non-payroll deduction transfers to credit union employee accounts.

Fictitious and Unauthorized Loans

A fictitious loan exists when the credit union disburses funds to an account in the pretense of granting a loan, but no actual loan was made. Unauthorized loans are loans made in the name of real members without their knowledge or consent. General characteristics are:

- The embezzler creates some or all the documentation creating the loan, forging signatures as necessary.

- The address used for mailing member statements and account verifications is under the control of the embezzler (a post office box, the embezzler's home address, or the credit union's own address). The AIRES loan and share download allows examiners to perform various share queries for determining if possible shortages exist. Sometimes the embezzler simply destroys the statements before they leave the credit union.

- The embezzler usually uses a direct payment method (i.e., cash payment) rather than payroll deduction.

Methods of detecting unauthorized or fictitious loans include:

- Reviewing loan documentation for discrepancies in the documents, such as validity of dates, legitimacy of signatures, or evidence of tampering;

- Verifying the borrower's name and address from non-credit union documents, such as telephone books, city address directories, credit reports, and certificates of title, sponsor records, or directory assistance;

- Comparing the address in the loan file with the address in the credit union's computer records;

- Comparing the address listed in the loan documentation against the addresses of credit union officials or employees;

- Comparing the signatures on loan documents, including signatures approving the loans, with the credit committee members' signatures or those of any other employees authorized to approve loans;

- Comparing the member's signature on the note with the signature on the membership card; and

- Verifying by telephone the accuracy of loan information with the purported borrower.

In most credit unions, examiners find it impossible to review all loan files for evidence of unauthorized or fictitious loans, and a random

sample of loans may not uncover such a scheme. The following red flags may indicate that there is a cause to examine certain loans:

- "Next payment due date" more than 60 days in the future;
- Loans not reported as delinquent, but the records indicate interest due;
- Repayment of principal not current, but records indicate no interest due;
- The original and the current loan balance approximately the same when the payment schedule indicates that the current balance should be significantly less;
- Unusual loan payment, interest rate, or balance or one that differs significantly from the typical credit union loan (i.e., zero interest rate loans);
- No payment for 90 days but loan not listed as delinquent;
- Member's share balance less than the current loan balance on a share secured loan; and
- Collateralized loan, but no outside third party documentation in the files confirming the existence of the collateral or the credit union's lien. (Credit union-generated documents and other form letters are not acceptable documentation.)

Loans to Employees and Family Members

Another type of internal shortage is a fraudulent loan in the name of the embezzler or the embezzler's family members. Generally, the perpetuator has not followed loan policies and procedures and ignores repayment and collateralization criteria.

Procedures that might assist the examiner in uncovering fraudulent loans include:

- Reviewing loan policies that relate to loans to employees, officials, and their family members;

- Reviewing loans to current employees and officials for current payments, valid approval signatures, and adequate share balances for share secured loans.

Theft of Member Shares

The following steps detail how theft of member shares can occur. First, the embezzler drafts a withdrawal check payable to the member, forges the endorsement, and cashes the check. Second, the embezzler completes a cash withdrawal voucher, which the credit union posts to the member's account. Finally, the credit union transfers funds from the member's account to an account under the embezzler's control. This type of embezzlement generally occurs in relatively inactive accounts (no loans) and conceals the embezzlement by diverting the member's statement before it leaves the credit union, altering it, or preparing a new statement.

To verify theft of member's shares, the examiner should:

- Scan accounts with relatively large balances, no loans, and significant withdrawals or transfers. For withdrawals, verify the signature on the check with those on the membership card. If the signature is questionable, pull other documents signed by the member to test authenticity. If the signature is still doubtful, consider first whether the signature may be by a party with authorization to sign, for example those with a power of attorney;

- Compare records of inactive accounts from a year ago with current inactive accounts. Then check the member statements for those member accounts that do not appear on the most recent inactive list;

- Review the other account if a withdrawal is by transfer to another account. Generally these transfers go to another account of the member or the account of a family member; and

- Contact the member directly or by telephone to determine the legitimacy of the withdrawals.

Overdrawn Accounts

A relatively simple method for creating a shortage is to overdraw a share or share draft account with no intention of repaying the overdrawn amount. Indicators of this type of embezzlement include negative balances in accounts, nonassessment of nonsufficient funds (NSF) fees or reversal of such fees, posting of drafts out of sequence, manual clearing of checks, and frequent appearance of insider names on the NSF check listing. Examiners should analyze the negative share and share draft report during the examination at various cut-off dates rather than just at month-end to uncover overdrawn amounts that credit union staff may have "fixed" at month end. The accounts most likely to contain unresolved amounts include those of credit union management, accounting department personnel, and family members of these individuals.

Theft of Loan Protection/Life Savings Insurance Claim Proceeds

Theft of loan protection/life saving insurance claim proceeds takes several forms:

- The embezzler increases the share or loan balances of a deceased member and steals the insurance proceeds once the credit union files and receives a claim;

- If the embezzler believes the beneficiary is unaware of the insurance, he steals the credit union check for the insurance proceeds, forges the endorsement, and cashes the check in the credit union; or

- The embezzler creates a fictitious account for a deceased nonmember, files a claim with the carrier, and keeps the proceeds check for his own use.

When the examiners suspect this type of shortage, they may obtain confirmation by requesting from the insurance carrier a copy of the claims register for the credit union. They compare this register to the credit union's records. Through spot-checking, they contact the beneficiaries to verify disbursements indicated in the credit union's records.

Theft of Credit Disability/Credit Life Insurance

Misappropriating credit life or credit disability claim checks, refunds, or dividends constitutes theft. Although the member pays premiums for this insurance, the insurance company makes dividends and refund checks payable to the credit union and sends them directly to the credit union. The procedure for detecting this form of shortage involves requesting the appropriate registers from the insurance company, tracing the proceeds through the credit union's records, and verifying with beneficiaries the actual receipt of the funds.

Theft of Receipts by Collection Agencies

This shortage involves misappropriation of credit union receipts from collectors of delinquent or charged-off loans by either credit union employees after remittance to the credit union or by the collectors themselves. To confirm these shortages, the examiner should secure a register of all collection loans from the collector and compare the balances with the credit union's records for discrepancies. To determine whether collectors are misappropriating funds, the examiner should contact the member directly to verify that the credit union applies all payments to the loan balance.

Embezzlement through the Credit Union's Expense Ledger

Embezzlement through the expense ledger usually occurs through overpayment of salaries, payment of personal bills or other personal expenses. Comparing credit union salaries, confirmed through board minutes or other documentation, with amounts paid per the expense ledger can detect this embezzlement. The examiner should check disbursements for proper invoices in the credit union's name.

Theft of Closed Accounts

In another common form of embezzlement, the embezzler steals an entire account balance and closes out the account. The embezzler usually targets retired or out-of-town members with no outstanding loans or account activity. The embezzler either forges the endorsement on the share withdrawal check or transfers the money from the member's account to an account under the embezzler's control.

To document theft of closed accounts, the examiner should obtain a list of recently closed accounts, examine the final member statement for unusual transactions, compare the signatures on the final withdrawal check with those on the membership card, and, if

necessary, verify the closing of the account directly with the member. For accounts closed by share transfer, the examiner should review the account of the transferee and, if necessary, confirm the transfer with the original member.

Deposits in Transit

The embezzler can conceal a shortage by increasing deposits in transit to cover the amount stolen. A detailed examination of bank reconciliations can confirm this shortage. Embezzlers can also use deposits in transit to conceal kiting (discussed later in this chapter.)

Unapplied Data Processing and Suspense Accounts

Inflating the unapplied data processing suspense accounts by individuals with responsibility for reconciling or correcting these accounts can also conceal a shortage. These accounts show the amount of unprocessed transactions rejected by the information processing system, often due to timing differences. The examiner should determine whether the amount in the unapplied data processing suspense account appears large relative to the size and operation of the credit union. Moreover, examiners should ensure that they can identify individual items in the account and that these items clear in a timely manner.

Kiting

Kiting is depositing a check from an account with non-sufficient funds to cover a withdrawal of funds from another account with non-sufficient funds. Kiting may involve one or more persons and can be internal or external. It usually involves credit union employees, because they have access to the records daily and are familiar with policies and procedures. The credit union should design internal controls to prevent kiting. Types of kiting are:

- Internal kiting - usually involves credit union employees. The most common forms of employees kiting are:

  - Two share draft accounts - continually writing drafts between the two accounts without sufficient funds to cover all drafts written.

- Regular share and share draft accounts - continuous transfer of funds between the two accounts without sufficient funds to cover all transactions.

- Share draft and Line of Credit - writing share drafts to pay amount due on a line of credit without sufficient funds in the draft account and then accessing the line of credit to pay share draft overdrafts.

- Share draft - delay in processing transactions to prevent an overdraft.

- ATM - delay in processing transactions to prevent a negative balance.

- Share account - negative balance without fees or interest being charged.

- Employee kiting – reviewing employees' account statements or transaction history for the most recent two to three months will usually detect employees' kiting. If the statements contain numerous transactions in a short time, the examiner should make a more in-depth investigation.

- External kiting - pertains to members' accounts. External kiting schemes usually involve the credit union and one or two other financial institutions. A member writes share drafts or checks against one or both of the other financial institutions. The member has insufficient funds in that institution to cover the check. Credit union employees should analyze any account that indicates large check deposits and equally large cash withdrawals within a short time. If they uncover a kiting scheme, management should not release large cash withdrawals before receiving the actual funds from the deposits made. Telephone verification will not catch external kiting as the member may immediately withdraw funds from the institution on which the check was written.

Burglary, Robbery, and Larceny

Except when the loss presents a material risk to the credit union and to the NCUSIF, an examiner normally need not make a contact when learning of a burglary, robbery, or larceny. If examiners decide to make an on-site contact, they should contact their supervisory examiners. The examiner will determine that the officials have:

- Notified surety and made necessary claims; and
- Mailed the SAR to the FinCEN (if applicable).

During the examination or supervision contact following the burglary, robbery or larceny, the examiner should detail pertinent information about the incident in the report.

False or Fraudulent Statements

§1014 of Title 18 of the United States Code makes it a federal crime for anyone to knowingly make a false statement or report, or to willfully overvalue any land, property, or security, for the purpose of influencing in any way the action of a federal credit union on any application, advance, discount, purchase, purchase agreement, repurchase agreement, commitment, or loan or any change or extension of any of the same, by renewal, deferment of action or otherwise, or the acceptance, release or substitution of security therefore.

Among the most common acts coming under §1014 are forging of co-maker's signature on the note, making false statements as to ownership or value of property offered as security for a loan, and false statements as to the purpose of a loan. The officials should obtain as much evidence as possible to support a potential bond claim. A sworn affidavit from the person whose name was used is usually sufficient.

The credit union officials should use caution when they discover an instrument containing an apparent forgery of the name of a relative. Frequently, these persons will claim that they gave permission for use of their names. Consequently, proving the loss is difficult since the credit union could not proceed against the person.

The examiner should use extreme care in dealing with possible violations of §1014 of the US Code. Incorrect statements about

ownership or value of property or about the purpose of a loan may not necessarily represent a violation under §1014 unless the person making such statements knowingly makes them with willful intent to mislead the credit union. The examiner should contact the supervisory examiner if any doubt exists about an alleged violation.

When a violation occurs, the examiner should determine that the credit union has notified surety and filed a SAR with the FinCEN (if applicable). If the board of directors declines to report a violation to surety and the FinCEN, the examiner should ask the supervisory examiner about the process of reporting a violation.

Mysterious Disappearance

Losses may occur in federal credit unions through the mysterious, unexplainable disappearance or misplacement of property. Credit union blanket bonds often cover the losses either as a standard feature or as a rider to the bond. If the credit union discovers a mysterious disappearance, it should review the bond to determine if surety covers the loss. On rare occasions, examiners may encounter credit unions that use mysterious disappearance rather than to name a person responsible for embezzlement in order to avoid confronting or taking action against that individual or to hide the real cause for a loss.

The surety and the FinCEN should be notified only when the circumstances of the mysterious disappearance lead officials to conclude that a criminal act occurred.

Federal credit unions' bonds do not cover tellers' overages and shortages. Management should avoid nuisance claims and must clearly identify the loss of the funds. For example, if the cash is short $100 at the end of the day, this is a teller's shortage and therefore not a claimable item. On the other hand, a mysterious disappearance occurs if member John Doe gave the treasurer $100 that the treasurer placed in a desk drawer and later cannot locate.

Workpapers and References

- Workpapers
  - Supplementary Facts
  - Suspicious Activity Report

- References
  - *Federal Credit Union Act*
    §§107(6), 107(9)
  - *NCUA Rules and Regulations*
    Part 703 - Investments and Deposits
    §702.3 - Full and Fair Disclosure Required
  - *Accounting Manual for Federal Credit Unions*
  - Electronic Fund Transfer Act - Regulation E
    NCUA Letter No. 96-CU-3, Suspicious Activity Report

WARNING SIGNALS - APPENDIX 27A

Warning Signals

- Attempts on the part of the treasurer, the manager, or an employee to postpone or delay the examination or the supervisory committee's audit.

- General conditions of books and records are unfavorable. Records not posted currently or out of balance for long periods of time.

- Failure of personnel to produce records for which they are responsible, or attempts on their part to delay access to records or cash on hand.

- Extreme nervousness or evasiveness in answering questions by personnel during examinations and audits.

- Failure of key personnel to share work or records with other employees. Attempts on the part of promoted employees to retain control of certain records because they "know the work."

- Failure of personnel to take vacations or attempts of personnel to retain control over records during vacation.

- Excessive personal spending habits of employees relative to the standard of living possible on their visible income, often indicated by heavy drinking, gambling, big cars, or expensive parties.

- Personal checks or IOUs used to balance petty cash or change funds.

- Inadequate bank records. No provision made for the reconcilement of cash received with bank deposits. Failure to deposit all collections intact so that they can be identified.

- No receipts for cash transfers between the credit union office and field collectors or between employees in the credit union office.

- Cash overages and shortages not recorded.

- Missing notes, ledger cards, or records of past transactions, particularly canceled checks and member share and loan ledger cards.

- Unusual and rapid increases in delinquent loans, without apparent accompanying causes such as strikes or layoffs, or long-term delinquencies for which there is not a satisfactory explanation.

- Unexplainable decreases in assets and in member share account balances at a time when the credit union should be growing.

- Credit union expenses unreasonably out of proportion with gross income.

- Loans to credit union officials, members of their families, or employees in excessive amounts.

- Inadequate information on loan papers of credit union officials, members of their immediate families, and employees. Excessive delinquency on these loans.

- High percentage of no-response accounts during positive account verifications mailed to the members' homes. Over a period of time, a pattern appears involving the same no-response accounts.

- Verification letters returned to the credit union office instead of to the supervisory committee. Lack of control by the supervisory committee.

- Failure of the board of directors to establish necessary and adequate control over operations.

- Failure of the supervisory committee to perform comprehensive audits as required by law.