

Case Study

Internal Controls

Commercial Bank Examination

Based on the following information developed through the course of a bank examination, determine what internal control deficiencies you should report to the Examiner-In-Charge and recommend discussing with management.

You are examining a 70 million-dollar commercial bank and have been assigned the responsibility of gathering information regarding the bank's system of internal routine and controls. You have first been assigned to check collateral and safekeeping. The exam team members reviewing loans have provided you with a sample of borrowers with descriptions of jewelry and stock held as collateral in safekeeping.

You ask the Executive Vice President (EVP) for access to the collateral and safekeeping records. They are just opening for the day, so she asks the receptionist for assistance opening the vault. The EVP completes the first half of the combination lock on the main vault door and asks the receptionist to complete the second half of the combination and the main vault door is opened. The receptionist leaves and the EVP opens the vault compartment containing all of the bank's negotiable collateral. She then opens a vault box containing these items, and you check to see if your sample is properly recorded on the collateral register and present in the sealed packets marked for each borrower. All items are properly recorded and accounted for, so the EVP reseals the packets. You did note that there were some unnumbered sealed packages and the EVP explained these were unrecorded as to contents but are said to contain valuable coins left by customers for safekeeping.

Later that day, one of the newer exam team members informs you that while reviewing the dormant account procedures they found that dormant accounts are included with active accounts on the deposit trial balance. Also all the IT exception reports including dormant account activity are left with the Senior Vice President in the loan department. Furthermore, although the internal auditor spot checks dormant account signature cards, the cards are conveniently accessible to all tellers in order to verify withdrawals.

While reviewing the cash item ledger maintained by the head teller, you note the teller next to the head teller's window is out to lunch and one of the loan officers is handling the teller's cash temporarily due to the increased lobby traffic during lunch hours. You also note that tellers consistently leave their keys in their cash drawers while going to lunch. During spells of customer inactivity, the loan officer handling the teller's work used the on-line memo post terminal to apply loan payments received in the mail. Using the teller supervisor override key, the loan officer was able to handle both the teller postings and loan entries with little problem. You also noticed a teller opening the bags left in the night depository and preparing a deposit slip for cash found in one of the bags.

During the exam you were also responsible for reviewing the loan reconciliation as of the loan review date. You did this at the note teller's window so that the teller could explain any differences, should it become necessary. While you were there, you saw that there were several blank notes signed by the customers in the note tray. The note teller stated the loans would be processed shortly for vacationing borrowers or cancelled if not funded. They were only for the customers' convenience if they needed additional funds, which could then be obtained by a phone call with the proceeds credited to their checking accounts. As you proceed with your business, you make several other observations about the way notes are approved. After reviewing the Board minutes you discover that the board of directors does not review any charged-off loans, giving the president full discretion. However, charged off notes are segregated and under joint custody.

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During the exam you have had a number of occasions to talk to the General Ledger Bookkeeper who makes all journal entries to the general ledger. This person is very friendly and extremely helpful and appears to be the only knowledgeable person about operations at the bank. In addition to general ledger work, the bookkeeper also works as part-time relief teller and other responsibilities include monthly reconciliation of "due from" correspondent bank accounts. You check further on this matter and find that reconciliements are reviewed by the auditor and that the general ledger bookkeeper is not authorized to sign checks drawn on these banks. A spot check of debit and credit tickets reveals many instances of insufficient detail describing transactions with such tickets only initialed by the person making the entry. A discussion with the administrative officer reveals that the bookkeeper has not taken a two-week vacation for several years. Apparently, she always takes two one-week vacations in the spring and fall to Las Vegas.

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Other matters are brought to your attention. Accumulated cash over/short differences are maintained in two respective general ledger accounts, but such differences are not accumulated for individual tellers. Unissued official checks are held under the joint custody of a secretary and the auditor. Cashiers checks are numbered only when issued. All employees are required by management to maintain their checking accounts elsewhere other than the subject bank.

After the preceding observations are made, an appointment is made with the auditor who is very cooperative and who appears quite proud of the audit department. The auditor explains that his department is directly responsible to the vice president in charge of operations and to no one else. Detailed monthly audit reports are submitted to the vice president, and the auditor relies on this officer to furnish the board of directors with the substance of these reports. While you are at the auditor's desk, the officer in charge of the bookkeeping operation calls to inform the auditor that Thursday, the 14th, will be a good day for the audit staff to conduct one of the periodic audits of the bookkeeping department. The auditor, recognizing that things will be relatively slow in the bookkeeping operation on that particular day, agrees with the suggestion and thanks the officer for the reminder.

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A. Tellers

- 4 1. Tellers should maintain control of their own cash drawer keys at all times.
- 13 2. A record should be maintained on individual cash shortages as well as aggregate totals.
- 4 3. Loan officers should refrain from teller function, if needed a separate drawer is advised.
- 6 4. Access to supervisory override keys should be carefully guarded and loan officers needn't have use for such an important item.
- 7 5. Night Depository transaction should be processed under joint custody.

B. Collateral and Safekeeping

- 1 1. The EVP has singular control over negotiable collateral, whereas joint custody is advised.
- 2 2. Safekeeping of packages containing valuables is not advised; however, if it is done, bank and customer should retain a copy of an itemized inventory.

C. Dormant Accounts

- 3 1. Dormant demand accounts should be separated and exception reports under dual control.
- 3 2. Internal auditor needs to check exceptions reports periodically along with all withdrawals.
- 3 3. Signature Cards for dormant accounts should be under joint custody.

D. Notes

- 8 1. Pre-signed notes should be prohibited.
- 5 2. Loan officers should not be posting payments on a memo-post, on-line terminal not assigned to him/her.
- 9 3. Board directors should review all loans to be charged off.

E. General Ledger

- 10 1. General Ledger bookkeeper should have no other duties, especially not as a teller.
- 10 2. Due from accounts should not be reconciled by the G/L bookkeeper.
- 11 3. General ledger tickets should contain complete and detailed information.

F. Audit

- 16 1. The auditor should report directly to the board, not bank management.
- 17 2. Scheduling audits with the operations department defeats the purpose and element of surprise.
- 14 3. The auditor should not have access to unissued checks.

G. Miscellaneous

- 12 1. Proper vacation policy calls for two consecutive weeks from the bank.
- 15 2. Pre-numbered cashiers checks are accepted common practice and recommended.