

SCICAP Credit Union: A Theft of \$2.7 Million over 37 Years

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ABSTRACT

SCICAP Credit Union failed as a result of an embezzlement scheme by a long-term employee that went undetected over a period of 37 years. Through this case, the student is exposed to the concept of internal controls, and also will discuss how internal controls can be established and maintained within a financial institution setting.

The student will reflect on the responsibility of the Board of Directors and Supervisory Committee for the well being of a financial institution, as well as issues that may be faced if one were in a supervisory role of an organization and suspicious of an active fraud. This case allows students to understand and apply internal control concepts at several levels of Bloom's Taxonomy within the setting of one case.

Keywords: Fraud examination, internal controls, auditors, case study

BACKGROUND

The SCICAP Credit Union was a small credit union based in Chariaton, Iowa (USA). The credit union was chartered in 1968 and established to serve the banking needs of various municipal employees within the rural area of Iowa. The small Credit Union had 828 members and \$2 million in assets.

Ten years after its inception, management made an employee hire that would eventually lead to its demise. From the time Linda Lee Clark was hired in 1978 to the time she was terminated in 2015, she managed to embezzle over \$2.4 million dollars. The total amount embezzled was more than what the credit union had in assets at any given point in time.

Mrs. Clark managed to embezzle the credit union assets right under the wings of employees, the CEO, the Supervisory Committee and Board of Directors. For thirty-seven years Mrs. Clark was able to maintain two separate sets of books on the credit union data processing system. Mrs. Clark was the only credit union employee with access to the system, and if others requested access, including the CEO, she refused to grant it. If management suggested that Mrs. Clark take a vacation, she declined and never missed a day of work throughout her thirty-seven year tenure as an employee.

Of the two databases Mrs. Clark maintained on the system, one database maintained all deposit and loan balances members would expect to see upon review of monthly statements. The second database contained altered financial information that was used to provide required financial reports to regulators and call reports. The balances in the altered database were adjusted by amounts that were removed from customer accounts. Mrs. Clark was able to re direct deposits from account holders to accounts of her children, as well as her personal account. Mrs. Clark was diverting approximately \$60,000 per year from customer deposit accounts to her own accounts as well as her children.

As Mrs. Clark had full control of database systems, statements provided to customers were overstated to reflect what the balance should show. If a transaction caused an account to have insufficient funds due to a lower actual balance, Mrs. Clark was able to cover the balance without the customer ever becoming aware of the insufficient fund balance.

Credit union employees, the board of directors, or supervisory committee never uncovered the fraud and had no idea that there was any fraud at any point in time. The only reason that the fraud became known was because Mrs. Clark decided to report it due to her age and fear of dying in prison in the event she ever was caught. Upon surrender to authorities, Mrs. Clark pled guilty to embezzlement and is subject to up to 30 years in prison.

After the fraud was reported, the NCUA (National Credit Union Association) who is the United States Federal credit union regulator took over operation of the credit union. The NCUA closed the credit union down and transferred deposits and assets to another credit union in the area. The NCUA, who is also an insurer of accounts in the event a credit union goes insolvent, also restored customer account balances to what they should have been.

Who is Responsible for this Crime Not Being Discovered?

A credit union provides many of the same services as a traditional bank, but is owned by account holders (known as members) where stockholders own banks. One additional significant difference between credit unions and banks is that credit unions are tax-exempt as they are considered a not-for-profit institution. Each depositor within a credit union owns one share of ownership and has one equal vote on official matters. Credit unions are established to represent a specific group of people, such as employees of a specific organization or geographic region. Governance of a credit union is maintained through a board of directors and supervisory committee. Board members and supervisory committee members are account holders within the credit union who are nominated and voted to their positions by the general membership based on the one vote per member model.

Role of the Board of Directors

Members of a credit union board of directors serve on a volunteer basis. The board of directors has final governing authority over all credit union matters. In a vast majority of credit unions the board will hire a CEO who manages day-to-day operations. The CEO reports to the board on a regular basis, at least monthly, but the board has final say on all operational decisions. Even as volunteers, when one serves as a member of the board of directors they have a fiduciary responsibility to all members of the credit union. Fiduciary responsibility means that the board member is legally charged to always act in the best interest of credit union members, even if the decision that is in the best of interest of general membership is not in the best interest of the individual board member. Due to the responsibility bestowed, board members should have a financial background and proper experience to understand the management of a financial institution. Based on the limited scope of membership many credit unions have, a board of directors with financial background is not always possible. Many credit unions are governed by board members who have limited experience and gain experience on the job, or through training sessions managed by the NCUA.

A typical expectation is that board members have full access to all financial information and full access to all other information that would be used within the day-to-day operating decisions. A qualified member of the board of directors should have the knowledge and skill to understand the operations and performance of the credit union with no need to question the CEO, employees or other members of the board.

Role of the Supervisory Committee

The board of directors is required to work with the supervisory committee in the management and oversight of the organization. Another name for the supervisory committee is the audit committee. Many will define the supervisory committee as the ‘watchdog’ of the credit union. Supervisory committee members should be independent of the board, though many supervisory committees may have one member who also serves on the board to assure open communication between the two groups.

The primary role of the supervisory committee is to on an annual basis complete a supervisory audit and present audit results to the board of directors. At a minimum of once every two years the supervisory committee must perform a verification of account balances.

The primary responsibility of the supervisory committee is to provide assurance that the board of directors is safeguarding the credit unions assets and that management is within compliance of policies and procedures of the credit union. Results of the supervisory committee audit are to be reported to the credit union membership at the required annual membership meeting, which is open to all account holders. A major part of the aforementioned responsibilities of the supervisory committee is to review internal controls, investigate all member complaints and provide recommendations to the board of directors for safeguards and policy changes to reflect the best interest of members. Like membership on the board of directors, this is also a volunteer position. Larger credit union supervisory committees often enlist the help of outside accounting firms to conduct the required annual audit and assist in matters. Smaller credit unions, such as SCICAP often conduct all procedures by the supervisory committee members using protocols provided by NCUA without the help of professional accounting firms. Supervisory committee members also have a fiduciary responsibility to membership in the same manner as the board of directors.

QUESTIONS

Part I

1. The supervisory committee of a credit union has a responsibility of establishing and setting internal controls for the credit union. Define what an internal control is and provide examples of policies and procedures organizations can utilize as internal controls.
2. In the specific instance of SCICAP Credit Union, being a small credit union with few employees, what are some specific internal controls that you would recommend to the board of directors and management to protect the integrity of member account balances?
3. Imagine that you are a member of the credit union supervisory committee, and you are aware that Mrs. Clark has exclusive access to the credit union reporting databases. You communicate the concerns to the board of directors, as well as the CEO and see no action taken to resolve the situation. A common response that a CEO and board may provide in a case such as this is “Mrs. Clark has been here for years, and does a great job, so we have nothing to be concerned with.” What recourse do you have to resolve the concern?

Part II

To answer questions to part II, please visit the website of the National Credit Union Association (NCUA) at <http://ncua.gov>.

1. Visit the ‘small credit union’ learning center. Based on the material presented within this website, what should the supervisory committee have done that may have helped detect this fraud, or prevent it from ever occurring? Please cite specific areas from the website within your answer.
2. Looking at the governing structure of a credit union, specifically the CEO, board of directors and supervisory committee, could any of these individuals be found negligent and held responsible for losses incurred by the embezzlement? Explain and provide support from the NCUA website.
3. Imagine that you are an accountant for an accounting firm that specializes in small credit unions. You have been asked by another credit union to conduct a supervisory committee annual audit. The reason this prospective Credit Union is seeking your services is in response to the failure of SCICAP Credit Union. Prepare a letter to the Supervisory Committee of the credit union discussing specific procedures and internal controls you would suggest a credit union utilize to prevent a fraud such as SCICAP from occurring.

IMPLEMENTATION GUIDANCE

Learning Objectives

The learning objectives of this case are as follows:

- To develop a basic understanding of how a financial institution operates. Specifically to explain management structure and responsibility for protecting the integrity of assets, and related policies.
- To review the definition of internal controls, as well as identify common internal controls that one would find within a variety of organizations.
- To develop or reinforce analytical skills and require that internal control concepts be applied to management decisions of a business entity.
- To develop or reinforce necessary communication skills required of a business professional.

Presentation Notes

This is a simple case that can be utilized to develop internal control background initially in the introductory accounting course, or for an auditing course to more in depth reinforce the workings of internal controls. The learning objectives reflect students in both areas of study.

Ability to Alter The Case to Classroom Needs

The requirements of this case have been split into two separate blocks based on requirements and expectations specific to the instructor and course. Part I of the case questions are designed to test the lowest levels of Bloom’s Taxonomy to ‘understand and explain’ internal controls. Part II of the case questions are designed to demonstrate understanding at higher levels through the ‘apply, analyze and create’ functions of Blooms Taxonomy. These higher levels are demonstrated through the student ability to utilize the National Credit Union Association (NCUA) website to make recommendations, draw conclusions, and create a document to communicate findings in a professional manner as expected of a professional accountant. The communication of findings in a client letter is an important skill for the development of a professional accountant as reported by Lafrancols (1992).

The questions in Part II are intended to introduce and develop the higher level critical thinking skills required on professional examinations such as the 2017 American Institute of Certified Public Accountants (AICPA) Uniform CPA exam (AICPA 2016), and to develop skills that are argued to be a common disconnect between accounting education and the profession (Jackling and DeLange 2009; Yu and Churyk 2013). This case can also serve as an effective measure to teach a crucial accounting concept consistent with Ashbaugh and Johnstone (2000). Based on the background of the specific course taught, instructors may select to assign parts I or II independently of each other.

Use as Written Assignment or Discussion Case

For this case to be successful as a written assignment, prior to coverage of this case, it is suggested that the instructor:

- Briefly review principles of internal control. Assigned reading from an appropriate course textbook is encouraged. Students need to understand basic principles of internal control. This is assessed in Part I of the case.
- Have the student imagine that s/he is a member of the supervisory committee of this credit union that should have detected this theft. The case provides a description of the role the board of directors and supervisory committee play in credit union management to assist in this role-play.
- Discuss the theft, how regulators inspect a financial institution, how they would be provided information, and the source of this information.
- Assure that students understand how credit unions such as SCICAP operate in a manner very similar to banks, and how frauds can be common within these settings.

This case was not tested as a discussion case, but it could be utilized as one. As a discussion case, instructors may wish to have students prepare by reading the case first and answering one or all of the questions in Part I. In class, the instructor could have students present their answers to part I, and as a class utilize the NCUA website to answer question 1 of part II together, and allow students to share opinions and thoughts on Question two. The client letter requirement can be a concluding assignment where students would reflect on their learning as they prepare the letter.

Timing

As a written assignment, this case will require approximately twenty minutes to introduce the case and provide background on the fraud. Students reported that it took them approximately 3 hours to read the case, and complete all questions, including the client letter in Part II.

As a discussion case, it is expected to require approximately an hour of advance preparation by the student. The student will need to read the case, and also review and develop a familiarity of the NCUA website where analysis will generate answers to questions in Part II. An instructor should be able to spend approximately one hour in class discussing the case.

Classroom Validation

The case was tested during an introductory accounting course, which blended financial and managerial accounting coverage at two private institutions in the United States. The case was tested as a written assignment, which is preferred by the author as opposed to a discussion case. Table 1 presents a summary of results based on the rubric utilized. Anonymous feedback was received from students within the courses through a likert scale rating responses from 1 to 5. 1 = strongly disagree and 5 = strongly agree. Results of student perceptions from the case are presented in table 2.

Table 1: Summary Grading Rubric
N = 28

Task	Potential Points	Student Average
Clear definition of internal controls	10	9
Provides examples of policies and procedures organizations can utilize	15	13
Provides adequate recommendations to the board of directors	15	13
Can provide an opinion on recourse that a member of the supervisory committee would have in the event concerns are not adequately addressed by management	15	14
Can cite specific areas from the NCUA website discussing supervisory committee responsibility	15	12
Provides discussion (with support) on the possible negligence of the board and supervisory committee	15	11
Can communicate advice to potential client clearly in a client letter.	15	12
Total	100	84/100

Table 2: Summary of Student Survey Responses
N = 28

Survey Question	Mean Response
This case improved my understanding of internal controls	4
This case improved my understanding of the importance specific internal controls have within a financial institution.	4.6
This case helped me reinforce my written communication skills.	3.2
I found this case interesting	4.1
This case was a positive learning experience	4
I would like to see more cases such as this in future classes	4

A significant portion of the students did perform well on the case, and also found the learning experience beneficial, and interesting. The impressions of the students are consistent with performance per the grading rubric. In one of the courses tested, end of course teaching evaluations contained the following comments:

“Great case, taught the importance of internal controls”

“Case made me think how careful management has to be to trust any employee. Wow. Learned a lot from the case.”

No negative comments from the students were reported.

The area of the weakest perceived learning was improvement of communication skills, but with the mean above 3 this still is a positive measure of learning. Instructors may wish to provide additional discussion on professional communication as part of the case assignment prior to assignment of the case. During the testing of the case, there was little discussion on how to write a professional letter. Students were provided a template of a professional letter with little instruction. It is also important to note that the class sections where this case was tested did have a higher than average percentage of non-traditional students. These students often have more professional experience than traditional students and may not need the additional experience in communication as required by traditional students, and see less value to the need of client letter preparation as part of the assignment requirement.

TEACHING NOTES

The purpose of this case is to 1) teach internal controls; and 2) apply internal control practices in a comprehensive case, so that the student can easily connect concepts to application, and see all levels of Bloom's Taxonomy in a comprehensive manner. In the first question asked, the student was required to demonstrate a basic understanding of what an internal control is, as well as provide general examples of internal controls, but not a specific application to the case. It is important that the student can first state what an internal control is and secondly produce examples that common internal controls within an organization are, while referencing the following categories:

- Clear statement of responsibilities
- Maintain and protect adequate records
- Have adequate insurance
- Separation of duties
- Utilize technology
- Have employee functions independently reviewed

After students can define and provide general examples of internal controls, students in the second question should based on prior responses present an opinion on controls that could be utilized. There is not one correct answer to this question, but specific examples should be based on the need for an increased separation of duties; that the former employee should never have had exclusive access to the system. Also, that the president of the credit union (or employee designee) should be routinely reviewing the work performed. It is very common within credit unions for a designee to review transactions, system access and to report any suspicious transactions conducted by employees to the supervisory committee. In small credit unions in which there is not an internal auditor working for the organization, a member of the supervisory committee may have access to the system and the ability to directly review employee activity. Having a mandatory vacation policy would have also required another individual to perform the task of the employee and uncover the second deposit database.

The third question brings in the question of ethics, and the responsibility of an individual to report actions. At the introductory level, students who have familiarity with Sarbanes-Oxley, specifically in the USA may assume that the act applies in this instance. As a non-public entity there is no Sarbanes-Oxley mandate. As the case does state that the supervisory committee has a fiduciary duty to members, there is a legal and ethical obligation to report concerns to appropriate officials outside the credit union, but this should only occur if the board and management have not been responsive initially. Based on the facts of this case the board or supervisory committee had no knowledge or suspicion of the theft. Whether or not they should have had knowledge is for later discussion. If one has knowledge or suspicion and cannot obtain support to investigate further from other supervisory committee members, the board or management, there is a responsibility to report concerns to the NCUA who regulate the behavior of the credit union. If a board member or supervisory committee member is aware of wrongdoing and reports it, the individual can be absolved from violating fiduciary duty. If one is aware of wrongdoing and does not report it, there can be significant penalties assessed to the individual.

Part II of the case requires the student to take the content from Part I, and specifically apply it to SCICAP Credit Union using NCUA regulations as to responsibility to implement adequate internal controls.

The first question requires the student to utilize the NCUA website as well as guide to develop an understanding of responsibilities the Board, Supervisory Committee and management have for the situation. The first question provides a basis to address the second question relative to liability these parties may face, and negligence. Suggested analysis could include:

Under chapter 3 of the Supervisory Committee Guide, section 3.02 states that it is a requirement to review audit findings and ensure management take the necessary corrective action. As in the previous question, if one has a concern, one must document it and then make sure the action taken by management "must be adequate to correct the findings." Section 3.05 also states that one should "use the examination report as a resource to help with identifying and improving any weaknesses . . . audit report(s) should also document material deficiencies in polices." Lastly in this chapter, if one believes that that an action or lack of action may affect the credit union, one "should exercise authority to take action (suspend a board member or executive office by calling a vote) or contact the examiner, the NCUA regional office, or state supervisory authority.

In chapter 4, the guide lists several additional procedures that the supervisory committee should consider shown below. Some of these could have been implemented in the case study and possibly prevented the fraud.

- Conduct surprise cash counts
- Reconcile or verify the accuracy of the credit union's bank reconciliation for three concurrent months
- Review employee accounts for preferential treatment or unusual activity. This procedure might have led to findings on Mrs. Clark's accounts and her family's accounts.
- Review internal control reports.
- Ensure that all employees take at least one week of continuous vacation. Mrs. Clark did not take any vacation in 37 years. This should have been a red flag.

Section 4.15 also states that supervisory committee members have "access to all of the credit union's records, without exception." As Mrs. Clark denied this access, this should have been a red flag.

Under section 7.07 the guide lists several items that should be the focus of supervisory committee members when reviewing internal controls. Some "flags" which may have drawn the committee's attention in the case of the SCICAP Credit Union include:

- One or two people do the work due to limited staff size.
- Lack of board approved policies.
- Lack of segregation of duties (no dual controls).
- Lack of mandatory vacation policy for all employees.
- Failure to maintain adequate audit trails.
- Record keeping problems.

Appendix 8A lists a very specific checklist for internal control of cash in bank. A few from this list, which would apply to the case study include:

- Are bank deposits prepared by an official or employee who does not serve as a teller? This is to test for proper segregation of duties. Mrs. Clark performed both so this should have been a red flag.
- Are all check signers authorized by the board of directors? This determines if internal controls prevent check signers from also posting transactions to the general ledger. This was not the case with Mrs. Clark.
- Do persons not directly involved in handling cash or the accounting records consistently on a monthly basis prepare bank reconciliations promptly? Again proper segregation of duties was not the case for Mrs. Clark – another red flag.
- Does the supervisory committee, internal auditor, or other management employee periodically review bank account reconciliations? This is recommended to strengthen internal controls. This was not happening in the case of the SCICAP Credit Union.

If procedures as outlined were followed, it is hard to believe that management, the board or supervisory committee could have not been aware of any wrongdoing.

The second question requires the student to utilize the analysis from the previous question and make a determination if there was negligence based on the information provided. Though there is subjectivity as to a correct answer, it is reasonable to argue that the board of directors, CEO, and supervisory committee could all be found negligent and held responsible for losses incurred by the embezzlement. These positions are a serious matter. The overall success of the credit union is dependent on these positions. People in these roles understand and fully accept their fiduciary responsibilities to the credit union members and they must maintain the members' best interest at all times. Part of this role is to catch and prevent fraud. In section 3.08 of the guidebook, NCUA states the "inability to fulfill the duties of your office can only bring harm to the credit union and its members . . . under certain circumstances (bad faith, negligence, dishonesty, etc.) NCUA can impose sanctions against management and penalties against the credit union." Both the *Truth in Lending Act* and the *Equal Credit Opportunity Act* contain a liability provision to protect members against noncompliance by the credit union management. Based on the magnitude of Mrs. Clark's behavior, it can be easily argued that the management team did not adequately complete their duties.

The third question serves the purpose of development and reinforcement of communication skills. For undergraduate students utilizing the case, this may be a first experience at development of a client letter, while a

graduate student might be more experienced in professional communication and find this portion of the case less value added. The instructor should provide samples of how a client letter is formatted prior to the assignment, so that the student has guidance. There is not one specific letter as a correct answer, but evaluation should look at style of communication, and ability to communicate findings as reported within previous questions. Sample letters that were submitted by students during the testing of the case are located in Appendix A.

REFERENCES

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APPENDIX A: SAMPLE CLIENT LETTERS

These sample letters are as submitted by the student, and there have been no changes or proofreading conducted by the author of this case.

Sample Letter 1:

To Whom It May Concern,

A supervisory committee serves an even greater function in smaller credit unions because there is limited ability to effectively implement internal controls. This is because there are fewer staff members to perform the functions, which results in less segregation of job responsibility. Basically, at a small credit union, the supervisory committee functions to help compensate for these limited controls. A thorough and exhaustive review should be completed on the credit unions internal control of cash in particular. A complete checklist for this is included in the Supervisory Committee Guide for Federal Credit Unions. Overall the supervisory committee should be on the lookout for the following items:

- One or two people do the work due to limited staff size
- Lack of board approved policies
- Lack of segregation of duties (no dual control for key area such as cash)
- Strong control of an area by a single employee
- Lack of mandatory vacation policy
- Failure to maintain adequate audit trails
- Record keeping problems (statements are not reconciled)

Some specific examples from the checklists which help with guidance include:

- 1) Are bank deposits prepared by an official or employee who does not serve as a teller? This checks for segregation of duties – bank deposit preparation would be separate from teller functions.
- 2) Are all check signers authorized by the board of directors? Determine whether internal controls prevent check signers from also posting transactions to the general ledger.
- 3) Do persons not directly involved in handling cash or the accounting records prepare bank reconciliations promptly each month? Recommended for proper segregation of duties.
- 4) Does the supervisory committee, internal auditor, or other management employee periodically review bank account reconciliations? Recommend at least quarterly review to strengthen internal controls.

In a small credit union where one person performs several jobs it is critical that quarterly the auditor is present during the process, verifies the reasonableness of the process, and checks /tests the log of backups and data reconciliations. These extra steps help when the segregation of duties is not feasible.

In addition to the steps mentioned above, the Supervisory Committee Guide for Federal Credit Unions recommends these additional procedures to assure proper internal control:

- Reconcile or verify the accuracy of the credit union's bank reconciliation for three concurrent months.
- Review all employee and family member accounts for unusual activity.
- Review internal control reports (override reports).
- Ensure that all employees take at least one week of continuous vacation.
- Assure complete access to all credit union records without exception.

In summary, there are several internal controls available for credit unions; however, the supervisory committee becomes even more crucial when dealing with a smaller credit union. The specific procedures and internal control checks listed above are recommended as a guide. A thorough plan, procedure, and checklist should be completed following the recommendations in the Supervisory Committee Guide for Federal Credit Unions.

Sample Letter 2:

To: ABC Credit Union Supervisory Committee
Subject: Re: Supervisory Committee Annual Audit
Dear Supervisory Committee members,

Thank you for your hiring me to perform your annual audit. I have reviewed your initial request and the reason for wanting the audit, and I agree that the issues at SCICAP Credit Union are perplexing. It is understandable that, as responsible committee members, you would want to audit your system and verify you are taking all of the necessary steps to prevent similar fraud and ensure the proper operation of your accounting system.

Below is a list of suggested areas that you can review in the NCUA's "Supervisory Committee Guide for Federal Credit Unions". If you need a copy of this document, you can download it from the NCUA's website at the following web address: <https://www.ncua.gov/Legal/GuidesEtc/GuidesManuals/supcomm.pdf>

The guide has all of information you would need for being successful, but I would draw your attention to the following areas, as they relate to the SCICAP CU situation:

- Chapter 2 – Explains what the supervisory committee is
- Chapter 4
 - Section 4.06 – Specific to internal controls
 - Section 4.15 – What records can be accessed by the committee
 - Section 4.17 – What to do if a problem is found
- Chapter 22
 - Sections 22.08, 22.09, 22.10 – specific to detecting fraud, and how to deal with it

Some of the things you can do immediately to mitigate fraud would be as follows:

- Eliminate Single Points of Contact – no one person should have control over any specific area
- Establish Random Audits – audits can be done on non-regular intervals, and unannounced.
- Aggressive or Unusual Employee Behavior- employees not willing to share information or provide access to client information on demand
- Denial of access to records – this is where SCICAP was negligent. They were refused access to records by a single point of contact employee, and didn't think to question it. No employee has the right to refuse a supervisory committee member, CEO, or board member access to any record in the credit union. If an employee is denying access, this should be a red flag

I think this will help you get started and also prepare you for what we will expect to go over during our audit. The key thing to remember is that, as a Supervisory Committee member, you have absolute authority over access to any record in the credit union, and you should not be afraid, or feel bad about asking for them. You have a fiduciary responsibility to audit the credit union, and a right to have your requests filled.

Thank you for your time and attention, and for your business. We look forward to working with you soon.
Best Regards,