La Caisse populaire de Shippagan

Contents

La Caisse populaire de Shippagan

Introduction

1.1 The Minister of Finance requested that we report to the Legislature on the sequence of events that led to the government's intervention in la Caisse populaire de Shippagan (LCPS). This request was under section 11(1) of the *Auditor General Act*. Under section 11(2) of that Act, the Auditor General has the powers of a commissioner under the *Inquiries Act*, which include the power to compel witnesses to appear.

1.2 Because of the nature of this work, we hired KPMG Forensic Inc. (KPMG) to perform the field work. In the course of their work, KPMG asked four members of the former senior management group at LCPS to consent to an interview; three declined. The former general manager agreed to an interview, but various impediments arose making it impossible to arrange the meeting. We did not compel any of these people to talk to KPMG. We decided not to invoke the powers available to us under the *Inquiries Act* since it was not our normal practice.

1.3 This report is based on information reported to us by KPMG Forensic Inc. In this report we have included the information that KPMG provided that helps to explain what happened. We have also included our own opinions of certain events. Those are identifiable because they are italicized. The opinions we have reached are our own, not necessarily those of KPMG Forensic Inc. They may also not be the same opinions or conclusions that others might draw. At the end of this report, we have six recommendations, responding to the request from the Minister of Finance to provide our "opinion on how to better prevent this type of exposure in the future."

Main points

1.4 *LCPS accumulated large losses that resulted in the Province of New Brunswick spending over $37 million of taxpayers' money, and providing a further guarantee of $16.5 million, to stabilize LCPS. The blame for the large losses incurred by LCPS requiring the infusion from government rests with one or more members of the LCPS former senior management group. Four members of senior management had their employment with LCPS terminated during*

2004. While management was to blame for the losses, there were others that could have prevented or minimized the losses earlier in the sequence of events, in particular the Board of Directors of LCPS during the period we reviewed.

1.5 *We believe that some of the actions of the former general manager, Mr. Belonie Mallet, caused financial harm to LCPS while at the same time appearing to be to his personal benefit. It is harder to say the extent to which the other members of senior management may have been involved in the same activities.*

1.6 *The irregular activities that occurred at LCPS were subtle. They were aimed at making the organization look profitable and look like it was growing, while at the same time covering up financial problems that were occurring. When the external auditors or the regulators started to get close to uncovering the problems, LCPS used aggressive actions to impede them from taking appropriate action. Because the organization appeared to be doing well, one or more members of the former senior management group were being paid large salaries and collecting large dividends on a class of preferred shares of LCPS.*

1.7 *The actions of management may have been partly motivated by a desire to have a successful business or to drive business growth in the region. They could have perhaps rationalized their actions by pointing to the fact that LCPS was a growing business that brought prestige to the area, that it was a supporter of local businesses, that it was helping people with poor credit reestablish their credit, and by actions such as gifting some LCPS preferred shares to a New Brunswick university.*

1.8 *Nevertheless, the common theme in the problems encountered at LCPS up until 2004 is failure. Failure of one or more members of the former senior management team to manage the business in a responsible manner; failure of the Board of Directors at the time to provide effective oversight to the organization; failure of the auditors certainly for the 31 May 2002 and 2003 fiscal year ends to report on the material misstatements in LCPS's financial statements; failure of CUSF/RMA*[1] *to recognize the seriousness of some of the issues they*

1. The regulatory oversight of LCPS fell under the jurisdiction of the Brunswick Credit Union Federation Stabilization Board Limited which operated under the name Credit Union Stabilization Fund up until about 31 March 2004, and operated under the name Risk Management Agency thereafter. In this report we have referred to this organization as CUSF/RMA.

identified in inspections carried out early in the time frame we examined; failure in the regulatory regime to give adequate powers to the CUSF/RMA to be able to act when it became aware of problems; failure of the Superintendent of Credit Unions to act on a timely basis despite having the authority to do so; and failure on the part of the government of the day to have in place a full time properly resourced Superintendent of Credit Unions during the critical time period.

1.9 *While CUSF/RMA must shoulder some of the blame, we found that once they realized the significance of what was occurring at LCPS, they did everything they could to try to stop it. They just did not have the authority to take meaningful actions. Had the Superintendent taken action when CUSF/RMA recommended it, the total loss to New Brunswick taxpayers would probably have been about half of what it eventually was.*

1.10 *The years in which the need for quick intervention should have been obvious and when that intervention could have minimized the losses that were ultimately realized, were 2001 and 2002. Swift action in 2003 would also have helped to reduce the losses, but by then many of the eventual losses had already accumulated.*

1.11 *The one success in this sequence of events was the realization by the new Board of Directors, and the new Board president, Ms. Jacqueline Hébert, in 2004 that LCPS was in trouble and that it needed supervision. The Board then requested that the Superintendent place LCPS under supervision.*

1.12 *The fallout from this problem is still going on. The work leading to the preparation of this report has cost taxpayers more than $1.4 million, spread out over three fiscal years. This cost also could have been avoided had organizational and regulatory oversight operated as they should have.*

1.13 We address the sequence of events that led to the government's intervention in LCPS under the following headings:

- management practices;
- allowance for losses;
- other accounting issues;
- management's compensation;
- governance issues;
- the auditors and their audits of the financial statements; and

- regulatory issues.

Management practices

Introduction

1.14 *One or more members of the former LCPS senior management group used a number of questionable management practices which they protected by being adversarial toward their external auditors and their regulators.*

1.15 *In our opinion, LCPS displayed contempt for the regulatory process, and in particular the oversight role played by CUSF/RMA. The harder CUSF/RMA tried to get LCPS to comply with rules, regulations, policies and legislation, the harder LCPS pushed back. On numerous occasions lawyers were engaged either to express legal opinions or because legal action had been initiated by LCPS.*

Loan related practices

1.16 KPMG identified a number of management practices related to the loan portfolio that appeared to be abnormal, as described below.

Establishing loan allowances

1.17 In the section of this report on Allowance for Losses, we identify a number of poor management practices related to the establishment of allowances for losses. A good summary of the many weaknesses in the approach management took to determining the appropriate amount of allowance to record can be found in a 1 June 2004 report from the firm Marcil Lavallée chartered accountants to CUSF/RMA.

1.18 Marcil Lavallée pointed out that in many cases LCPS had failed to adequately recognize the impairment of loans where the credit quality of the borrowers had seriously deteriorated and where there was no reasonable assurance of collecting the loans. They also identified that LCPS had failed to assess the impairment of connected delinquent loans and failed to assess the realizable value of security.

1.19 Marcil Lavallée also said that LCPS failed to assess loan delinquency for many line of credit loans and commercial line of credit loans in excess of authorized limits and they had failed to assess the impairment on large overdraft accounts with no authorized lines of credit, including those that LCPS had identified as high-risk.

Allowance not properly recorded in monthly financial statements

1.20 LCPS prepared monthly financial statements for internal use. KPMG learned through the interview process that the total allowance for impaired accounts was determined at the beginning of the year and was expensed monthly at an amount equal to 1/12th of the budgeted amount, rather than based on the best estimate at the time.

This approach meant that anyone looking at a monthly financial statement of LCPS, including its Board of Directors, would not have an accurate picture of the soundness of the amounts owing to LCPS. As we will see in the section on Allowance for Losses in this report, when CUSF/RMA raised this issue, LCPS responded by recording offsetting assets and liabilities to make it look like they were recording the allowance monthly. *This was an irregular response that appears to have been designed to deceive CUSF/RMA.*

1.21 The issue of recording monthly allowances was eventually reviewed by an arbitration panel formed by the Court of Queen's Bench as the result of LCPS appealing a decision of the Superintendent to the courts. The panel said that in its opinion:

> *…the Caisse should record the allowance for impaired loans, in the income statement, on a monthly basis. The period in which they calculate the impairment is monthly and the Caisse prepares monthly statements for their internal use. Having calculated the balance we see no support in Section 3025* [of the Canadian Institute of Chartered Accountants' Handbook] *for the deferral and amortization method used by the Caisse…We recognize that the recording of the actual change in the allowance each monthly* [sic] *could cause significant fluctuations in the monthly charge and suggest that this is reality and the Caisse's Board will be better informed of the actual results of operation by understanding the reasons for variances between budget allowances and actual allowances. It also may result in directives from the Board to assist management in granting loans to specific industries, etc. on a timely basis or making other decisions relating to credit granting at certain times.*

Loans in excess of prescribed limits

1.22 On various occasions LCPS allowed individual loans to exceed the maximum commercial lending limit of $1.0 million. In one case, at 31 May 2003, one company group had exceeded the limit by $1.5 million.

1.23 They also allowed the group maximum concentration limit of $2.5 million to be exceeded in a number of cases, one of which exceeded the limit by over $3.0 million.

1.24 LCPS' lending policies allowed overdraft accounts on a temporary basis of up to 45 days. The LCPS Lending Policies as approved by CUSF/RMA indicated a maximum overdraft for an individual member of $30,000 and a maximum total overdraft balance for LCPS of $150,000. The Board of LCPS had approved higher limits but those limits were not approved by CUSF/RMA. KPMG identified one situation where the overdraft was continuous and reached an amount of $2.1 million at 31 May 2004. KPMG identified examples where commercial borrowers were allowed to make payments on their loans from their overdraft account, even though those overdraft accounts exceeded authorized limits.

1.25 Many lines of credit were in excess of their individual authorized limits, reaching a maximum excess of $10.8 million at 31 May 2004, which was 139.1% of the 31 May 2002 excess.

1.26 KPMG found no evidence in the information provided to them that any member or members of the former LCPS senior management group consistently reviewed the loan details, credit worthiness and risk profile with CUSF/RMA as required by the *Credit Unions Act* (the Act), when the total aggregate of loans was in excess of the authorization.

1.27 The 15 May 2000 inspection report by CUSF/RMA noted variances on approval and application processes and security requirements in over 60 percent of the new personal lending accounts tested and over 90 percent of the new commercial lending accounts which were inspected.

1.28 LCPS was also in violation of paragraph 5(a) of Regulation 94-5 to the *Credit Unions Act* requiring that mortgage loans not exceed 75 percent of the lower of the selling price and the appraised value of the property. The position of LCPS as outlined in a 16 June 2000 response to the CUSF/RMA inspection report was that LCPS was relying on section 103 of the Act which required that every director and officer shall exercise the care, diligence and skill that a prudent person would exercise.

Out-of-jurisdiction loans

1.29 According to the regulations to the Act, subject to specific approval of the Superintendent of Credit Unions, which was never given, LCPS was limited to operating within New Brunswick. As such LCPS' membership and the loans that LCPS issued were limited to residents of New Brunswick. KPMG identified that LCPS issued $16 million in new out-of-jurisdiction loans in the year ended 31 May 2004. In total, $30.2 million of new out-of-jurisdiction loans were issued over the period 1998 to 2004. KPMG identified that as at

31 May 2004, LCPS had 146 loans at an interest rate of 29.9% that were owed by clients outside New Brunswick, with a total face amount of almost $1.2 million.

1.30 Based on email and other correspondence obtained by KPMG, it appears that out-of-jurisdiction lending was a business strategy of the former senior management group. One loan in particular was for $750,000 and was for a risky investment in a foreign country. KPMG found no evidence that the former senior management group performed any financial analysis of the loan. This loan was issued during the fiscal year ended 31 May 2000, and by March 2001, the company had stopped making principal payments on the loan.

High risk activities

1.31 *LCPS engaged in a number of high risk activities*. As early as 1998, the Superintendent had questioned LCPS' practice of offering above market rates of interest on deposit certificates to out-of-jurisdiction depositors.

1.32 LCPS later started to compete with other large lending institutions on various high risk products such as high interest rate loans but they had very little experience with such high risk products. One high interest rate loan product issued by LCPS carried an interest rate of 29.9%. KPMG identified that during the time period that LCPS was issuing high interest rate loans, between October 2001 and April 2004, they were issuing an average of 40 new loans each day.

1.33 CUSF/RMA and some Board members of LCPS reported that they had never seen a proper business plan for the new 29.9% interest rate loan product. KPMG was told that the loan recovery process for these high interest vehicle loans took approximately nine months to complete, and that initially, there was no one to follow up on the delinquent loans or to repossess assets.

1.34 During this same time period, LCPS was actively pursuing used vehicle dealers in New Brunswick, Quebec and other parts of Atlantic Canada. LCPS offered to finance people buying a vehicle from the dealer, and offered to provide the dealer with a line of credit or loan to finance the dealer's vehicle inventory. LCPS eventually had approximately 100 of these dealer arrangements in place.

1.35 LCPS was also extending higher risk credit to their regular commercial clients. For example, one commercial client was having trouble making loan payments – drawing on its already overdrawn line of credit at LCPS to do so. It also owed money to other lenders and those other lenders had priority over LCPS on many of the company's assets. On 6 June 2001 this company was in default of its loan terms with its other lenders. Despite this, LCPS extended the company an additional $1.6 million in loans from 31 May 2001 to 31 May 2003.

The flush process

1.36 KPMG learned through interviews that changes were routinely made to LCPS' loan portfolio files at the request of one or more members of the former LCPS senior management group. This practice was referred to as the "flush" process. The flush process appears to have been used by LCPS to allow for temporary adjustments to loan files. As a result of this process, the system aging and therefore the assessment of delinquent loans did not reflect the original loan agreements as reported to the Credit Committee of LCPS.

1.37 KPMG was told during interviews with staff and Board members that one or more members of the former LCPS senior management group would on occasion instruct staff to change the loan payment amounts from their original amount to one cent. That way, if the one cent plus accrued interest was paid, the loan would not appear on delinquency reports. KPMG identified 1,309 such changes; 1,038 were changed back to another value by the new LCPS management in 2004.

1.38 KPMG was also told that one or more members of the former LCPS senior management group would on occasion instruct staff to change the next loan payment date to a future date with little explanation. Since there can be legitimate reasons for changing a next payment date, it was not possible for KPMG to identify which of the 33,110 such changes they identified were legitimate and which were part of the flush process. They did determine that the distribution of the changes indicated that some of the changes were outside normal business practice. We understand that by changing the next payment date to a later date, a delinquent loan would not appear on the delinquency report.

1.39 KPMG was also told that one or more members of the former LCPS senior management group would on occasion instruct staff to change the due date on some loans with little explanation. Again, there can be legitimate reasons for changing a due date on a loan, so it was not possible to tell which of the 9,471 such changes identified by KPMG were part of the flush process. It appears that by changing the date on some loans, LCPS was able to move the due date into the next fiscal year, thereby making them appear not to be delinquent.

Documentation weaknesses

1.40 Loan file documentation was poor, and KPMG noted that the quality and retention of such documentation did not comply with regulation. For some of the loans examined by KPMG, little documentation existed, and where it did, the files were not complete. Where financial information was on file, in some cases there was no evidence on file that the information had been reviewed, and in cases where a financial analysis did exist it was often incomplete or inconsistent with other documentation on file.

1.41 KPMG identified a number of date changes in the loans for one company group, but did not find any documentation in the loan files for that group that supported the change in repayment dates with the requisite approvals.

Monitoring of employee loans

1.42 Based on the configuration of LCPS' computerized accounting system, employees with loan control access would have been able to alter their own loans. Any changes to employee loans were recorded on a system report that was available to the former LCPS senior management, but KPMG found no evidence that these reports were monitored.

1.43 We understand that for employee loans, each addition or modification of the terms of an existing loan required approval from the Credit Committee. KPMG found no evidence of any such approval.

1.44 KPMG did not find any transactions of value resulting in changes to the loans of employees or the former LCPS senior management that were considered unusual or preferential.

Adversarial approach

1.45 KPMG noted that there was in general an adversarial tone to the correspondence coming from LCPS regardless of the purpose of that correspondence. This adversarial approach was evident in a number of situations.

Relationship with Grant Thornton

1.46 Management's adversarial approach was a factor in the resignation of Grant Thornton as external auditors after the 31 May 2001 year end. KPMG interviewed Grant Thornton and were told of two reasons for their resignation. First, there was increasing conflict with one or more members of the former LCPS senior management group on the adoption of emerging accounting rule changes, proposed changes and on the acceptance of proposed journal entries. Also, Grant Thornton felt that one or more members of the former LCPS senior management group had an approach to Grant Thornton's staff that was abusive.

Dispute with CUSF/RMA over the need for a general allowance

1.47 A dispute between LCPS senior management and CUSF/RMA over the interpretation of section 3025 of the Canadian Institute of Chartered Accountants' (CICA) Handbook and the need to record a general allowance for losses developed as early as 2001. CUSF/RMA issued ten orders to LCPS on 16 January 2003, under subsection 265(1) of the Act, one of which included the requirement that:

> *By no later than February 28, 2003 the Caisse shall determine an amount to be recorded in its financial statements and other books of account as a general allowance (the "General Allowance") for impaired accounts (in addition to [allowances for specified impaired loans]). Such determination shall be made by the Caisse acting reasonably, in good faith and in accordance with sound business practices.*

1.48 LCPS received opinions from two accounting firms comparing the Handbook requirements to the requirements specified by CUSF/RMA, in an apparent attempt to refute CUSF/RMA's interpretation of section 3025. *We believe that both of these opinions were vague and did not refute CUSF/RMA's position that a general allowance should be recorded.*

1.49 On 3 February 2003, LCPS requested a hearing by the Superintendent on the 16 January 2003 orders; a pre hearing was held in May 2003, which was followed up with written submissions to the Superintendent in June 2003, as well as a hearing in June 2003. On 19 December 2003, the Superintendent upheld the order requiring the establishment of a "General Allowance" modifying it only for the compliance date. On 16 January 2004, LCPS appealed the Superintendent's decision to the courts, which established an arbitration panel to determine if CUSF/RMA's orders related to recording allowances were consistent with section 3025 of the CICA handbook. With regard to the establishment of a general allowance, the panel said "…in our opinion the … requirement to determine and record a General Allowance is consistent with a proper interpretation of section 3025."

Dispute with CUSF/RMA over the right to issue mortgages in excess of 75% of value

1.50 As stated earlier, LCPS was in violation of section 5(a) of the Regulations to the Act which required that mortgage loans not exceed 75 percent of the lower of the selling price and the appraised value of the property. CUSF/RMA raised this issue in its inspection report that was released on 6 May 1997.

1.51 LCPS' position on this issue as explained in a 16 June 2000 response to the 15 May 2000 CUSF/RMA inspection report was that LCPS was relying on section 103 of the Act which required that every director and officer shall exercise the care, diligence and skill that a prudent person would exercise. LCPS believed that section 5(a) of the Regulations contradicted section 103 of the Act and they were prepared to take the issue to court.

1.52 During this dispute over mortgage lending, the LCPS Board passed a resolution to withdraw its membership from Credit Union Central of New Brunswick (CUCNB) and therefore CUSF/RMA. It is unclear why this resolution was passed, however it was reversed on 5 October 2000.

1.53 On 14 November 2000, pursuant to section 265(1) of the Act, CUSF/RMA ordered LCPS to comply with section 5(a) of the Regulations. About a year later, in a letter dated 31 October 2001, LCPS noted that with the creation of a control officer for the mortgage portfolio, the problem should be solved.

1.54 By way of example, KPMG examined a personal loan for two mortgages for a total of $253,000 on two properties with a total appraised value of $248,000. These mortgages were fully repaid.

Approach to the 2002 inspection by CUSF/RMA

1.55 Based on correspondence, in 2002 LCPS began questioning the authority and findings of CUSF/RMA. It began when CUSF/RMA requested that certain information be provided before the start of the on-site portion of the 2002 inspection. LCPS replied that the information would be available to the inspectors when they arrived on-site, and that LCPS would not be able to provide space for the inspectors in the main office building. The 2002 inspection eventually led to the issuance of ten orders from CUSF/RMA to LCPS. LCPS legal counsel issued a letter to the Superintendent and to CUSF/RMA on 8 January 2003 expressing concern that CUSF/RMA was not respecting the Act by altering their inspection process to an enterprise risk management approach. LCPS also requested a hearing with the Superintendent about the 10 orders issued by CUSF/RMA. On 21 March 2003 CUSF/RMA requested that the

Superintendent place LCPS under supervision. On 19 December 2003, the Superintendent issued a decision upholding the 10 orders issued by CUSF/RMA. On 16 January 2004, LCPS informed CUSF/RMA that they were appealing the Superintendent's decision on the 10 orders to the Court of Queen's Bench.

Inaccurate information supplied by former management

1.56 In October 2001, CUSF/RMA asked about the approved limits of the loans to one group of companies. LCPS replied that while the total owing was $1,176,000, $200,000 was a line of credit. Also since there was a $450,000 loan guarantee by the Province of New Brunswick against the remaining $976,000, the balance that was not totally secured was $526,000 which LCPS maintained was within their authorized limit. When KPMG examined the outstanding loans of that group of companies on the date in question, they found that in addition to the amounts disclosed by LCPS to CUSF/RMA the group of companies owed an additional $830,953, which meant the group of companies had exceeded the commercial lending limit.

1.57 On 13 April 2000, the Province of New Brunswick Office of the Comptroller requested LCPS to confirm, as at 31 March 2000, the amount of total indebtedness of one company that had loans guaranteed by the Province. LCPS responded that the balance of indebtedness was $435,000. KPMG extracted data from the LCPS accounting system that indicated that the actual amount due on the date requested was $866,000.

1.58 As part of CUSF/RMA's October 2002 inspection, LCPS staff indicated that they had approximately 25 vehicle repossessions that had not been completed. However, CUSF/RMA identified that the total amount of vehicle loans that were delinquent by at least sixty days indicated that there were 232 vehicles that should have been repossessed at that date.

Management's relationship with the Board of Directors

1.59 In the Governance section of this report we discuss the fact that the Board relied heavily on one or more members of the former senior management group. KPMG was also told that some Board members felt uncomfortable addressing the need for Board training with the former general manager. They were told that training was not required and that they would learn on the job.

Allowance for losses

Introduction

1.60 *In this section we provide our analysis of the allowance for losses recorded by LCPS management during the period under review. In this analysis we have looked at a number of factors, some of which overlap. Also in this section we have arrived at our estimate* *of the amount of the allowance that we believe should have been recorded for each year end from 31 May 1996 up to and including 31 May 2003. From this analysis, we have concluded that one or more members of the former senior management group of LCPS were knowingly understating the amount of allowance recorded in the financial statements. Understating the amount of allowance was the primary method they used to conceal the true state of LCPS' loan portfolio.*

Value of loans and allowances reported in LCPS financial statements

1.61 The following table provides a summary of LCPS' outstanding loans receivable and the allowance recorded by management against those loans for the fiscal years ended 31 May 1996 to 31 May 2004. The allowance for the year ended 31 May 2004 was determined by the new management of LCPS.

Table 1
LCPS Outstanding Loans and Allowance
Years Ended 31 May
($ millions)

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Loans Receivable	111.3	120.7	147.4	163.0	170.6	172.2	206.5	234.2	250.8
Allowance	0.9	0.9	1.0	1.1	0.9	1.5	3.8	6.9	56.2
Percentage	0.8%	0.7%	0.7%	0.6%	0.5%	0.9%	1.8%	2.9%	22.4%

1.62 We have divided our analysis of the allowance into two time periods, 1996-2001 and 2002-2003.

1996-2001 allowances

Analytical review of the allowance

1.63 The first thing we noticed from the figures in Table 1 was the decline in the allowance percentage for the fiscal years ended 1997 to 2000.

1.64 According to KPMG's analysis of the financial statements of other New Brunswick Credit Unions, the ratio of allowances to loans receivable in the period from 31 May 1998 to 31 May 2001 was constant at 1.1% as shown in Table 2.

Table 2 Ratio of Allowances to Loans Receivable for Other Credit Unions ($ millions)			
Year	**Outstanding Loans**	**Allowance**	**Ratio (%)**
1998	271.2	3.1	1.1
1999	291.7	3.2	1.1
2000	320.9	3.4	1.1
2001	360.0	3.8	1.1

1.65 *In the next table, we have recalculated the LCPS allowance for the 1996 to 2001 time period using two scenarios; the first assumes that the allowance percentage was at least 0.8%, as it was at 31 May 1996, for each fiscal year until 31 May 2001, and the second assumes a percentage of 1.1% for each year. Under these scenarios the effect would have been:*

Table 3 Additional Allowance Required with Minimum Allowance Ratio of 0.8% and 1.1%					
Year	**Allowance Recorded ($ millions)**	**Allowance (Ratio Minimum of 0.8%)**	**Additional Allowance ($ millions)**	**Allowance (Ratio of 1.1%)**	**Additional Allowance ($ millions)**
1997	0.9	1.0	0.1	1.3	0.4
1998	1.0	1.2	0.2	1.6	0.6
1999	1.1	1.3	0.2	1.8	0.7
2000	0.9	1.4	0.5	1.9	1.0
2001	1.5	1.4	0	1.9	0.4

1.66 *There were other signs that the allowance required extra scrutiny in these years, for example the large increases in the value of outstanding loans would be cause for concern.* The breakdown of the outstanding loans by category was:

Table 4						
Breakdown of Loan Balances and Percentage Increases in Loan Balances						
	1996	1997	1998	1999	2000	2001
Loan Type	($ millions)					
Personal	52.4	56.2	73.9	86.7	93.5	92.1
Mortgage	23.1	25.9	31.5	34.7	34.5	31.8
Commercial	35.8	38.6	42.0	41.6	42.6	48.3
	(% increase)					
Personal		7.3	31.5	17.3	7.8	(1.5)
Mortgage		12.1	21.6	10.2	(0.6)	(7.8)
Commercial		7.8	8.8	(1.0)	2.4	13.4

1.67 *This analysis raises questions such as why would the value of personal loans increase by 31.5% in 1998 and then increase by a further 17% in 1999? The Shippagan area was not growing at that rate, so some possible explanations would include: loans moved from other institutions to LCPS; existing borrowers increasing their loan exposure; LCPS attracting borrowers from outside its traditional business area; or LCPS lending to borrowers that it considered too risky to lend to in the past. It is unlikely that all of the increase would have been from people changing lenders, and the other possible reasons would suggest riskier loans. Similar questions can be asked about mortgages, which increased by 12.1% in 1997, 21.6% in 1998 and 10.2% in 1999.*

1.68 The CUSF/RMA expressed concern about the quality of LCPS' loans in the inspection report it released on 16 December 1998 in which it commented on the general lending philosophy of LCPS- calling it aggressive. CUSF/RMA also noted in that inspection report that 14 new commercial accounts had been opened which required the approval of the CUSF System Credit Committee, but that 10 of the 14 had not been forwarded to CUSF for approval.

1.69 *We believe that the large increases in loan balances in this period imply that the risk of default was probably also increasing.*

Specific allowance

1.70 When establishing allowances, one or more members of the former senior management group of LCPS looked at specific amounts owing to LCPS and decided on the amount of allowance to record for each one. KPMG analyzed certain loans owing to LCPS during the 1997 to 2001 time period. *This analysis indicated that* *there were signs of problems with the specific allowances recorded by LCPS against its loans for the 2001 fiscal year. Three sets of commercial loans issued to three groups of companies illustrate the problems.*

1.71 The outstanding balances owing for the loans for these three groups of companies for the 1999, 2000 and 2001 fiscal years were:

Table 5
Loans Owing by Three Company Groups
Years Ended 31 May
($ millions)

	1999	2000	2001
Group A	1.0	1.2	1.4
Group B	0.4	1.1	1.7
Group C	0	0.1	1.4
Total	1.4	2.4	4.5

1.72 The allowances recorded in the year end audited financial statements of LCPS for these same loans were:

Table 6
Allowance on the Loans of Three Company Groups
Years Ended 31 May
($ millions)

	1999	2000	2001
Group A	0	0	0.1
Group B	0	0	0.2
Group C	0	0	0
Total	0	0	0.3

1.73 The Province had issued loan guarantees to LCPS for some of these amounts, and the 15 May 2000 inspection report issued by CUSF/RMA confirmed that the amount of the allowance recorded by LCPS was adequate. One of these companies had loans from other lenders and had pledged most of their assets to those other lenders.

1.74 *By 31 May 2001 it would appear that the allowances recorded for these specific groups of companies were insufficient. Two of these groups of companies had established a pattern of losing* *money – reaching a total of $2.0 million for their December 2000 year ends – and had negative equity as at 31 December 2000 of a combined $1.7 million. The third group of companies was relying on winning a lawsuit to become financially viable.*

1.75 By 31 May 2004, these three groups of companies owed LCPS about $14.4 million, and the allowance established by the new management group was $11.5 million, or about 80% of the total.

Need for a general allowance

1.76 Our analytical review was based on the assumption that the 0.8% allowance rate seen in 1996 is the appropriate base rate, however it only includes amounts for specific loan risks. Paragraph .04 of section 3025 of the CICA Handbook says:

> *The existence of impairment in an entity's entire portfolio of loans is identified by an assessment of the credit quality of individual loans and each of the groups of loans that comprise the portfolio. When practicable, impairment is identified on a loan-by-loan basis in accordance with the lender's judgment of the creditworthiness of individual borrowers. In some cases, however, the full extent of impairment present in a portfolio of loans cannot be identified solely by reference to individual loans. An assessment of the impact of recent events and changes in economic conditions, as well as general economic trends, may indicate that the credit quality of groups of loans to borrowers operating in particular industries or geographic areas has deteriorated. In such circumstances, the additional impairment that cannot be identified on a loan-by-loan basis is estimated collectively for the group.*

1.77 CUSF/RMA raised the issue of recording a general allowance in addition to the specific allowance in their inspection report that was released 16 December 1998. LCPS refused to set up a general allowance, and this set off a long running dispute between LCPS and CUSF/RMA over the need for a general allowance, as explained in the section on Management Practices in this report.

1.78 When new management was put in place in 2004, they established a general allowance of $22.8 million for the year ended 31 May 2004. This was 9% of the total value of all loans outstanding and it was about 40% of the specific allowance that was established. *However, because LCPS entered into some particularly risky lending in the 2002 and 2003 years, the factors that would have been* *considered in the 2004 general allowance would not have been the same in 2001 and earlier years.*

1.79 *We have prepared the following sensitivity analysis for the earlier years using 0.8% as the base rate for the allowance, and then calculating possible values for a general allowance using three different assumptions.*

Table 7

Estimates of a General Allowance at 50%, 100% and 150% of a Specific Allowance at 0.8%

	1996	1997	1998	1999	2000	2001
			($ millions)			
Total loans	111.3	120.7	147.4	163.0	170.6	172.2
Base Allowance (0.8%)	0.9	1.0	1.2	1.3	1.4	1.4
General Allowance (50% of base)	0.5	0.5	0.6	0.6	0.7	0.7
General Allowance (100% of base)	0.9	1.0	1.2	1.3	1.4	1.4
General Allowance (150% of base)	1.4	1.5	1.8	1.9	2.1	2.1

Estimated adjusted allowances

1.80 *Table 8 puts all of this analysis together. In doing so, we have recognized that the increases that would have resulted from the extra risk assessment or from increasing the base rate from 0.8% to 1.1% would probably overlap with the recognition of a general allowance. Therefore in this summary table we have included the original allowance, an adjustment to a base rate of 0.8% and an estimate of the general allowance. We have used a general allowance of 50% of the base allowance since it is our assumption that it would have been unlikely that anyone would have suggested a general allowance much higher than that at the time.*

Table 8

Estimated Adjusted Allowance

	1996	1997	1998	1999	2000	2001
			($ millions)			
Original Allowance	0.9	0.9	1.0	1.1	0.9	1.5
To Base Allowance of 0.8%	-	0.1	0.2	0.2	0.5	-
General Allowance at 50%	0.5	0.5	0.6	0.6	0.7	0.7
Total Estimated Allowance	1.4	1.5	1.8	1.9	2.1	2.2
New Allowance Rate	1.3%	1.2%	1.2%	1.2%	1.2%	1.3%

1.81 *The rates of allowance that result from this analysis are similar to the average rate of 1.1% for other credit unions during this time period.*

1.82 Something else to note from this time period are the comments in the inspection reports of CUSF/RMA regarding the allowance. The 6 May 1997 inspection report was generally favorable and said that the 28 February 1997 allowance of $986,134 was adequate. The next inspection report which was released 16 December 1998 demonstrated a higher level of concern on the part of CUSF/RMA as we described earlier in this section. However it concluded that the allowance of $1,016,400 as at 31 August 1998 was "adequate at this time." The final inspection report in this time frame was issued 15 May 2000 and CUSF/RMA generally agreed with the allowance of $879,000 as at 20 February 2000.

2002-2003 allowances

Increased risk

1.83 In each of 2002 and 2003 the bad debt expense increased significantly over the preceding year. While the expense increased with the growth of the loan portfolio, the expense in the fiscal years ended 31 May 2002 and 31 May 2003 did not adequately reflect the higher risk that LCPS was taking on in those years. The value of personal loans increased 23.1% in the 2002 fiscal year and 24.3% in the 2003 fiscal year even after the large increases in previous years. In fact in 2002 LCPS issued $14.5 million worth of loans with interest rates of over 25% and $8.3 million worth of loans with interest rates of between 15% and 25%. In 2003 they issued $16.3 million worth of loans with interest rates above 25% and $10.2 million worth of loans with interest rates of between 15% and 25%. By way of contrast the total of all loans issued in 1998 by LCPS with interest rates above 15% was less than three hundred thousand dollars. In 2002 and 2003 fiscal years, approximately 30% of all loans issued by LCPS were at these very high interest rates – a significant change to their risk profile. We have seen that the allowance rate on credit union portfolios tends to be low, however new management of LCPS determined that the allowance rate on the high interest rate loans needed to be 14.6% at 31 May 2004.

1.84 During this time period, overdraft accounts increased each year in number and amount. The number of overdraft accounts grew by 46.2 percent from 2002 to 2004. During the same time, the balance associated with overdraft accounts grew by 326.5 percent, largely due to the increase in the overdraft balance of one company from $6,336 as at 31 May, 2002 to $2,336,323 as at 31 May, 2004.

1.85 We understand that as a result of the overdraft accounts not being classified as either a line of credit or a traditional loan, the LCPS system did not report or age the overdraft accounts as a separate item. Based on the documents provided to KPMG, the former LCPS senior management did not appear to consider accounts with an overdraft balance when calculating the allowance for losses.

1.86 KPMG noted entries in the LCPS accounting records where payments made to the loan accounts of a certain company were funded by an increase in the overdraft account of that company, even though, prior to these payments being charged to the overdraft account, the company had exceeded the authorized overdraft limit by over $900,000. At the same time, the company's indebtedness exceeded the maximum commercial lending limit by $1.5 million. Allowing overdraft accounts in excess of the authorized limits to be used to pay down loan principal and interest amounts, resulted in increased credit exposure for LCPS, while not disclosing the true picture of the loan aging on delinquency reports.

1.87 A second company made loan payments funded by a line of credit that had exceeded authorized limits, resulting in the appearance that the loan was current.

1.88 The other significant change that occurred in this time frame was that CUSF/RMA started to disagree with the allowance recorded by LCPS. The inspection report issued 26 October 2001 said that the allowance as at 31 August 2001 needed to be increased by $1,282,000. However it appeared that even CUSF/RMA was aware that the problem was even larger. An internal CUSF/RMA memo dated 6 December 2001 noted that:

- LCPS is approving car loans for applicants with "super poor" credit ratings and at an interest rate of 29.9 percent.

- These high interest rate loans were not the type of lending to be funded with insured deposits and that orders should be issued telling LCPS to cease the practice.

- Many "severely delinquent accounts were not examined" in the last inspection and suggested that an inspection may be warranted just to give the delinquent loans a thorough examination.

1.89 The next inspection report by CUSF/RMA issued 10 January 2003 was even more severe, and it said that LCPS needed to increase its specific allowance as at 31 October 2002 by $5,429,488. It also indicated that "…commercial delinquency increased by more than 49% between September 2001 and 2002." The report went on to say:

> *The caisse's delinquency has been moving steadily upward for some time. It has reached a point now where CUSF considers it to be excessive compared to sound business practices.*
>
> *As noted by the substantial increase in allowances that are required, the delinquency in both sub prime and the commercial portfolio have increased sharply.*
>
> *We are very concerned with the sub prime delinquency due to the ineffectiveness of the collection* [and] *repossession process.*

1.90 The inspection report also highlighted some areas of increasing risk, such as unsound business practices, sub-prime lending, serious problems with adhering to lending limits and large unauthorized overdraft balances.

Estimated allowances

1.91 *These two inspection reports provide us with some additional data points for the 2002 and 2003 fiscal years. They show:*

Table 9
Allowance Recorded at Different Dates ($ millions)

31 May 2001 Allowance in the financial statements	1.5
30 Nov 2001 Allowance recorded by management	2.5
31 May 2002 Allowance in the financial statements	3.8
31 October 2002 Allowance required by CUSF/RMA	10.7
31 May 2003 Allowance in the financial statements	6.9

1.92 *Because of the significant risk in the loans that LCPS issued in 2002 and 2003, it is not possible to extend our analysis for the 1996-2001 period into 2002 and 2003. It is obvious from CUSF/RMA's work that even without a general allowance being added in, the allowance reported in the 31 May 2003 financial statements was significantly understated. While it is less obvious that the 31 May 2002 allowance was understated, the analysis shows that CUSF/RMA determined that the allowance needed at 31 October 2002 was $8.2 million higher than the allowance that was required eleven months earlier at 30 November 2001. But when management* *recorded its 31 May 2002 allowance, six months into that eleven month period, its allowance was only $1.3 million higher that the November 2001 number. Furthermore there was still no general allowance being recorded.*

1.93 *From this information we would estimate that the allowance that should have been recorded at a minimum would have been:*

Table 10 Estimated Allowance for Years Ended 31 May 2002 and 2003 ($millions)	2002	2003
Allowance as recorded in the 31 May Financial Statements	3.8	6.9
Additional allowance for 2002 suggested by 31 October 2002 inspection report	2.5	
Additional allowance for 2003 estimated based on 10 January 2003 inspection report		5.0
General allowance of 50% of specific allowances	3.1	6.0
Total Estimated Allowance	**9.4**	**17.9**

1.94 *As we have indicated, management could not point to CUSF/ RMA inspection reports confirming their allowance estimates in this time frame. In fact the inspection reports were showing very significant differences from the allowances being recorded by management.*

Specific allowance

1.95 Looking at the same specific loans we looked at for the 1999 to 2001 years, we see the following balances owing for the 2002 and 2003 years:

Table 11 Loans Owing by Three Company Groups Years Ended 31 May ($ millions)	2002	2003
Group A	1.6	2.5
Group B	2.5	3.4
Group C	2.9	4.7
Total	7.0	10.6

1.96 The total amounts due increased by \$3.5 million during the 2002 fiscal year of LCPS and \$3.6 million during the 2003 fiscal year.

1.97 The allowances recorded in the year end audited financial statements for these same loans were:

Table 12
Allowance on the Loans of Three Company Groups
Years Ended 31 May
(\$ millions)

	2002	**2003**
Group A	0.1	0.1
Group B	0.9	0.9
Group C	0.2	1.2
Total	1.2	2.2

1.98 KPMG also found an Equifax report dated 4 April 2001 that indicated that a number of creditors had registered claims against one of these groups of companies, but there was no change in LCPS' credit approach to that group.

Bookkeeping practices

1.99 *Also during this time period, KPMG identified that one or more members of the former senior management group of LCPS implemented a bookkeeping practice that appears to have been intended to make CUSF/RMA inspectors believe that higher allowances were being properly recorded when in fact they were not.*

1.100 KPMG learned through the interview process that the total allowance for impaired accounts was determined at the beginning of each year and was expensed monthly, based on 1/12 of the budgeted allowance. Each month, the difference between the required allowance, based on the review of the loans, and the budgeted monthly amount was recorded in a prepaid account or another balance sheet account. KPMG determined that this practice would have been followed from mid 2001 to at least the end of 2003, thus covering the 31 May 2002 and 2003 fiscal years.

1.101 For example, KPMG determined that, on 26 October 2001, the allowance for impaired accounts was increased by \$1,273,972. The offsetting entry was to the balance sheet account of prepaid expense. This accounting entry effectively allowed LCPS to produce a listing of the allowance for impaired accounts that demonstrated to

CUSF/RMA that the required allowance had been booked. However, this accounting entry did not charge the expense to the income statement so the assets and the equity of LCPS did not decrease as a result of the impairment. As explained below, at year end the prepaid expense was eliminated, but not all of it was charged to expense.

1.102 KPMG observed that as at 26 October 2001, the amount expensed should have been at least $1,309,842 whereas the accounting records reflected an expense of only $140,869. By the year end date of 31 May 2002 the amount expensed had increased to $709,604, still well below the amount that should have been expensed.

1.103 In addition, KPMG identified a number of unsupported date changes in the loans for one company including one that changed the loan repayment date from 11 April 2003 to 11 October 2003. This resulted in the loan repayment date being moved into the next fiscal period as LCPS' fiscal year end was 31 May.

Later estimates of allowance

1.104 It should be noted that the dispute between LCPS and CUSF/RMA on the amount of allowance needed as at 31 October 2002 was eventually referred by the Court of Queen's Bench of New Brunswick to an arbitration panel. Using the mid point of the panel's estimates from its 8 June 2004 decision, the panel confirmed 85% of the allowance suggested by CUSF/RMA in its inspection report for the specific loans the panel reviewed. The panel also said "…in our opinion the … requirement to determine and record a General Allowance is consistent with a proper interpretation of Section 3025."

1.105 CUSF/RMA hired Marcil Lavallée, chartered accountants, to estimate the amount of allowance required as at 31 March 2004. Their estimate was $26 million in specific allowance. *If we add in our 50% general allowance estimate, the 31 March 2004 total allowance would be $39 million.* The new management of LCPS estimated that the allowance required at 31 May 2004 including both specific and general allowance was $56.2 million. *These numbers suggest that our hindsight estimates of $9.4 million for 31 May 2002 and $17.4 million for 31 May 2003 may even be too low.*

1.106 In the 31 May 2005 financial statements of LCPS the new management included the following note: "The provision for impaired loans was not properly estimated by management in prior years. In addition, a general provision against loans, required under generally accepted accounting principles, was not booked."

Financial statement impact

1.107 In order to estimate the likely financial statement impact that recording additional allowances would have had, it is important to understand that management appears to have been using its accounting of allowance expense and patronage rebates to achieve a smooth annual net income of $700,000 as the first line in Table 13 shows. KPMG was told that the former general manager had indicated that it was necessary to reach a specific net income figure, but no explanation had been provided to the employees as to why. $700,000 was the same amount as the after tax impact on LCPS' equity of declaring annual dividends of $1,000,000 on LCPS's permanent investment shares; it was therefore the amount at which the preference dividends did not cause a reduction in equity.

1.108 *If the former management of LCPS had recorded allowances at the levels that our analysis suggests, it would not necessarily have had a direct impact on the net income for all of those years. That is because the annual expense for patronage rebates was a decision of the LCPS Board. In our analysis we have assumed that any increase in bad debt expense caused by recording the higher allowance would have been offset to the extent possible by a decrease in patronage rebates. Even if the total increase could have been offset by a reduction in patronage rebates, there would have been an impact on the balance sheet of LCPS because of the accounting treatment of the patronage rebates. The net result would have been:*

Table 13 Estimated Adjustments to LCPS Financial Statements	1996	1997	1998	1999	2000	2001	2002	2003
	($ millions except where noted)							
Surplus for the Year per the Financial Statements	0.3	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Increase in Bad Debts Expense	(0.5)	(0.6)	(0.8)	(0.8)	(1.2)	(0.7)	(5.6)	(11.0)
Reduction in Patronage Rebates	0.5	0.6	0.8	0.8	1.2	0.7	1.5	1.0
Adjusted Net Income (Loss) for the Year	0.3	0.7	0.7	0.7	0.7	0.7	(3.4)	(9.3)
Reported Equity	14.4	15.6	16.7	18.3	20.0	21.7	22.9	24.3
Reported Assets	153.4	162.8	170.9	192.6	208.5	242.1	277.3	291.1
Ratio of Equity to Assets (%)	9.4	9.6	9.8	9.5	9.6	9.0	8.3	8.4
Adjusted Equity	14.4	15.1	15.6	16.4	17.3	17.8	13.7	3.6
Adjusted Assets	153.4	162.3	169.8	190.7	205.8	238.2	268.6	270.9
Adjusted Ratio of Equity to Assets (%)	9.4	9.3	9.2	8.6	8.4	7.5	5.1	1.3

1.109 *This table shows that even with the increase in bad debts expense, it is likely that the net income for the years ended 31 May 1996 to 31 May 2001 would not have changed. The patronage rebates in those years would have been high enough to absorb the increased bad debts expense, and since the patronage rebates were not really rebated at all, their reduction would not have affected individual members of LCPS. The table also shows that while net income would not have been affected, both total equity and total assets would have been affected dropping the ratio at 31 May 2001 from 9.0% to 7.5%. This was still well above the required ratio for a credit union in New Brunswick.*

1.110 *The impact on the years ended 31 May 2002 and 2003 was more severe. For 2002 there would have been a loss reported of $3.4 million rather than a net income of $0.7 million. This should have prevented the payment of $1.0 million in dividends on the permanent investment shares, and instead of an equity-to-asset ratio of 8.3% it would have been 5.1%. For the year ended 31 May 2003 there would have been a loss of $9.3 million rather than a net income of $0.7 million and the equity to asset ratio would have been 1.3% - below the level required for a credit union in New Brunswick.*

1.111 *In our opinion, it is unlikely that, had the adjusted numbers been recorded, the changes would have triggered any different* *actions on the part of the regulators for any of the fiscal years up to and including the year ended 31 May 2001. The recognition of a large loss for the year ended 31 May 2002 would have been more likely to have caused some regulatory action.*

Other accounting issues

Introduction

1.112 *In addition to the inadequacy of the allowance recorded by LCPS, we identified three other questionable accounting treatments used by LCPS. These were:*

- *netting of account balances;*
- *recording of interest revenue on impaired loans; and*
- *recording of patronage rebates.*

Netting of account balances

1.113 Negative balances in overdrawn operating accounts were not considered as loans in the computerized accounting records of LCPS and so were not reclassified as receivable for financial statement purposes. Rather, these amounts were netted against regular operating account balances with the net amount included in members' deposits (payable) on the balance sheet. Accordingly, the full amount owing to LCPS was not readily apparent from the accounting system and, consequently, the financial statements.

1.114 If an LCPS member had two accounts, the first with a positive balance and the second with an overdrawn amount, and LCPS had a legally enforceable right to offset the two accounts and the intent was to settle on a net basis, then netting the amounts on the LCPS financial statements may be appropriate according to the CICA Handbook. Without this right of offset, netting would not be appropriate. If netting was not appropriate, there would not have been an impact on the net income for any fiscal year of LCPS, however the increase in the reported assets would have increased the required minimum equity balance for LCPS.

1.115 The value of the negative balances in overdrawn operating accounts was significant, growing from $4.4 million at 31 May 1997 to $32.9 million at 31 May 2004. *While LCPS would have had the right of offset for some of these negative balances, it is likely that some of them should have been reclassified and reported as amounts receivable by LCPS.*

Recording of interest revenue on impaired loans

1.116 Interest and service charge revenue was accrued on large loans that were in trouble, with no extra allowance against the interest. By continuing to accrue interest and service charges and minimizing the loan allowance on these same accounts, one or more members of the former LCPS senior management group would have affected the net income for LCPS during the periods of 1999 to 2004. KPMG noted that for one group of companies that had exceeded their authorized limits, LCPS continued to accrue interest and service charges on the lines of credit accounts to an aggregate amount of $1.7 million. CICA Handbook paragraph 3025.26 says "When a loan becomes impaired, recognition of interest income in accordance with the terms of the original loan agreement should cease."

Recording of patronage rebates

1.117 LCPS would annually declare patronage rebates. A patronage rebate:

> *…results in a distribution to the members of a credit union, based on the volume of business done with each member over a specified period. It represents an adjustment to amounts charged or credited to members as customers of the credit union, rather than a pro rata return on their investment as shareholders.*[1]

1.118 The recommended accounting treatment of patronage allocations is to:

> *...present the patronage allocation on the basis of its substance as an adjustment of income or expense transactions. Accordingly, the patronage allocation would be reflected in the income statement as, for example, a rebate of interest or fee income or additional interest expense.*[2]

1.119 In the case of LCPS, the patronage rebates were not paid out in cash, but were settled by issuing special surplus shares. *The rebates were declared each year and recorded as an expense and an account payable. The next year, the account payable would be removed and replaced by an increase in LCPS' special surplus shares in the equity section of the balance sheet. These shares would be issued in the name of LCPS members who would also receive a tax information slip informing them of the value of the shares they were credited with.* No cash distribution was ever made to the members and the special surplus shares were non-redeemable, non-voting and

1. CICA Handbook; *EIC 68 Patronage Allocations*; 1
2. CICA Handbook; *EIC 68 Patronage Allocations*; 1

had no dividend rights. *The special shares could not be sold or cashed in even when an individual ceased to be a member of LCPS.*

1.120 *The CICA Handbook defines expenses as "…decreases in economic resources, either by way of outflows or reductions of assets or incurrences of liabilities, resulting from an entity's ordinary revenue generating or service delivery activities."*[1] *It defines liabilities as "…obligations of an entity arising from past transactions or events, the settlement of which may result in the transfer or use of assets, provision of services or other yielding of economic benefits in the future."*[2] *In our opinion, during the time period we examined, the patronage rebates did not have any substance, and they should not have been recorded as expenses and liabilities by LCPS.*

1.121 Patronage rebates were about 7 percent of revenue for 1997 to 2003 as compared to an average of 5 percent for other credit unions. In two years in that time period, 1998 and 1999, the patronage rebates were approximately 10 percent of revenue. The total value of patronage rebates recorded ranged from $1.0 million to almost $1.8 million.

Management's compensation

Introduction

1.122 *It is our opinion that a member or members of the former senior management group managed to have the Board of LCPS put in place various compensation arrangements that provided senior management with a strong incentive to report good financial results – even to the extent of purposefully understating the allowance for losses. A member or members of senior management were able to convince the Board that the growth that LCPS was experiencing along with the annual results justified high salaries, extra compensation and very high dividend payments.*

1.123 In this section of the report we look at loans to LCPS employees, income reported on T4 slips, long service awards and permanent investment shares.

Employee loans

1.124 KPMG reviewed loans to certain LCPS employees including the members of the former management group. They did not find any transactions of value that they considered unusual or preferential.

---

1. CICA Handbook; *Section 1000, Financial Statement Concepts*; paragraph .38
2. CICA Handbook; *Section 1000, Financial Statement Concepts*; paragraph .32

Income reported on T4 slips

1.125 A 1 June 2004 report from Marcil Lavallée said that LCPS' total compensation package was expensive and not consistent with their competitors. It also identified that large bonuses were approved and paid to select LCPS employees annually, even though annual evaluations did not exist and there were no criteria to establish bonuses.

1.126 Based on KPMG's interviews with former Salary Committee members, the salaries of former senior managers were justified by the former general manager on the basis that LCPS was highly profitable and there was an increase in assets under management. It was also thought by the Salary Committee members that the salary increases would act as incentive for continued growth.

1.127 The following table shows the total of all compensation reported on T4s of the four former members of the senior management group up until 31 December 2003.

Table 14
Compensation of Former Senior Management Group as Reported on T4s

	1999	2000	2001	2002	2003
Total Compensation	$615,812	$639,295	$654,807	$939,020	$1,273,003
Percentage Increase		3.8%	2.4%	43.4%	35.6%

1.128 In addition, the four former members of senior management received a combined total of $819,515 in the calendar year 2004, the year their employment at LCPS terminated.

1.129 Also, in December 2003 one member of the former management group received an amount of $41,750 as reimbursement of travel expenses for travel between Shippagan and Bathurst for a five year period ending 30 November 2003. Since this was called a reimbursement of travel, it was not reported as taxable income. *We consider this payment to be irregular. The claim supporting the payment indicates that the individual drove exactly 21,000 kilometers in each of the five years of the claim and incurred exactly $1,000 in meal costs for each year. Furthermore, the individual in question had received payments in excess of $25,000 for travel, claimed regularly during the same time period.*

Long service award

1.130 KPMG was told by former members of the Salary Committee of the Board of LCPS that in 2000 or 2001, the former general manager of LCPS introduced a new form of compensation for which employees with ten or more years of service would be eligible. We discuss the process through which this was approved in the Governance section of this report. KPMG did identify that the compensation in 2003 of one member of the former management group included a payment under this long service plan.

Permanent Investment Shares

1.131 As mentioned in the Governance section of this report, in January 1996, LCPS introduced a new type of investment share for its members called "Les Parts Permanentes d'Investissement" or Permanent Investment Shares. These Shares were available as a limited offering to the members of LCPS. They were not tradable on any external market and LCPS maintained a prioritized list which was used to facilitate future transactions. The 29 January 1996 offering memorandum described these shares as non-voting, non-participating, and non-convertible, each with a face value of $1.00. The shares had repayment preference over other classes of LCPS shares upon liquidation of LCPS and they carried a right to cumulative dividends at a rate established by the Board. The shares were also redeemable by LCPS in an amount up to 10 percent of the value of the shares outstanding in any year at face value plus the amount of any dividends in arrears. The shares could only be sold to other members of LCPS through the purchasers and sellers lists maintained by LCPS.

1.132 Out of 5,000,000 shares issued by 4 June 1996, over 733,000 were owned by the former senior management group and their spouses and over 329,000 were owned by members of the Board of Directors. We understand that the ownership of the shares did not change much thereafter.

1.133 The original share offering contained a clause that limited individual ownership of the shares to 50,000 for the first four weeks of distribution, thereafter the maximum ownership per member was 500,000 shares. One member of the former LCPS senior management group and his spouse held more than 500,000 shares as of 4 June 1996. Furthermore, one other member of the former senior management group purchased more than 50,000 shares during the period of time that the 50,000 limit was in place.

1.134 According to the offering memorandum for these preference shares, an annual dividend could only be paid if LCPS attained a level of income sufficient to support the financial distribution and maintain the required level of equity as set out in the Act.

1.135 The approved dividend rate in 1996 was 10 percent, then, for 1997 to 2003 it was set at 20 percent. By way of contrast, a five year term deposit at LCPS was paying about 4 percent in 2003. The new Board of Directors declared a dividend of 5 percent on the permanent investment shares in 2004.

1.136 The four members of senior management and their spouses received almost $1.2 million in preference dividends from 1996 until 2003. Anyone owning these shares for the eight years from 1996 until 2003 would have received dividends equivalent to 150% of the face value of the shares.

1.137 The original offering of these shares stated that the minimum dividend to be declared would be equal to the highest interest rate on LCPS term deposits with one to five year terms on the date of the dividend declaration. For the period 31 May 1996 until 31 May 2003 this ranged from 4.58% to 6.45%.

1.138 *We believe the offering of the permanent investment shares was irregular. While the terms of the offering might have been attractive to potential buyers, it appears to us that LCPS did not fully disclose to potential buyers their intentions for declaring future dividends. We have based this on the significant amount of shares purchased by two members of the former senior management group and their spouses, along with the eventual declaration by the Board of an unusually high dividend rate of 20% each year.*

Governance issues

1.139 We have in our previous work on the governance of New Brunswick Crown Corporations defined governance as:

> *... the process and structure used to direct the business and affairs of a corporation with the objective of achieving the corporate mission. The process and structure define the division of power between the shareholder, board and management. They also establish mechanisms for achieving accountability between management, the board of directors, and shareholders.*[1]

1.140 *In our opinion, a functioning governance structure where the board of directors and management each have specific powers resulting in a clear separation of duties and accountability to other*

---

1. Office of the Auditor General of New Brunswick; *2005 Report of the Auditor General*, Volume 2; 2006; 110

stakeholders did not exist at LCPS during the period of time we examined. As a group, the Board of LCPS placed too much reliance on management. Former Board members told KPMG that the Board members did not have the requisite skills to effectively perform their governance duties.

Board of Directors

1.141 Subsection 83(1) of the Act says:

> *A credit union shall in its by-laws establish a fixed number of directors, which shall not be fewer than seven.*[1]

1.142 The Act also says:

> *The members of a credit union shall by ordinary resolution at the first meeting of the members and at each succeeding annual meeting of the members at which an election of directors is required, elect directors to hold office for a term established in the by-laws, which shall not exceed three years.*[2]

1.143 And

> *Subject to the by-laws of the credit union, a director is eligible for re-election but is not in any case eligible to serve as a director for more than nine consecutive years.*[3]

Excess terms

1.144 The provision in the Act referred to above which limits the total term of a director to nine years was implemented in the early 1990's. The result was that in 2003, five LCPS directors who had served for nine, twenty, twenty-one, thirty-one and thirty-six years all reached the end of their term limits. Just prior to the 2003 annual general meeting, all five of these directors resigned from the Board. They were then re-appointed a few days later at the 2003 annual general meeting.

1.145 In an internal Department of Justice memo dated 7 November 2003, the Superintendent made reference to a letter of complaint from a member and former member of the LCPS Board alleging that

---

1. *The Credit Unions Act*; Chapter C-32.2 of the Acts of New Brunswick, 1992
2. *The Credit Unions Act*; Subsection 85(2)
3. *The Credit Unions Act*; Subsection 85(3)

at its 2003 annual general meeting, LCPS elected Board members whose consecutive years of office exceeded the maximum allowed under the Act.

1.146 On 18 November 2003 the Secretary of the LCPS Board wrote to the Superintendent saying that LCPS had modified its by-laws to allow a director to be re-elected without a limit on the total number of years served.

1.147 On 22 December 2003 the Superintendent wrote to LCPS saying that the change to the by-laws was not approved because it was in conflict with the Act.

1.148 On 8 January 2004 CUSF/RMA wrote to the Superintendent saying that, because five of LCPS's seven directors were not eligible to serve as directors, it was the opinion of CUSF/RMA that LCPS was operating without a validly elected Board of directors, and so there was no body in place with the fiduciary duty to govern LCPS. The letter went on to say that in the opinion of CUSF/RMA, LCPS was in violation of the Act and so CUSF/RMA had passed a resolution to place LCPS under supervision.

1.149 On 15 January 2004 a special meeting was held where five new directors were elected. *This was the pivotal event that eventually caused LCPS to be placed under supervision.*

2003 Board election irregularities

1.150 The complaint that was received by the Superintendent about the 2003 Board election also alleged other voting irregularities. These included undue influence by the former general manager of LCPS, inappropriate use of proxy votes and the secret counting of votes by people who were not independent.

1.151 KPMG found evidence of the former general manager sending e-mails to LCPS staff saying who he would be voting for in the Board election. He listed the five people he was going to vote for; they were the five people who had already reached the nine year term limit. He also sent an e-mail saying that he was going to vote yes on the by-law amendment to remove the restriction on the number of years a Board member could serve. KPMG also identified in its review of commercial loan files that some companies signed authorizations giving their voting rights to the general manager of LCPS. KPMG was told by former Board members that the only counting of votes after an election was done by LCPS employees.

Lack of meeting documentation

1.152 KPMG was told management would set Board meeting agenda, and that a member or members of the former LCPS senior management group would distribute and then collect the agenda and minutes of the previous meetings and other information that was presented to the Board or its Credit Committee. The stated reason for this control over the minutes was to prevent the loss of sensitive LCPS business strategy information. The Board minutes KPMG was able to obtain lacked detail. Furthermore, the minutes did not contain information on attendees, or the names of individuals who made motions, seconded the motions or voted on the motions. The minutes did not contain any information about any discussions that occurred, and there was no evidence that previous minutes were reviewed and approved. As such KPMG was unable to identify evidence to support the actions of the Board or approvals that were granted by the Board.

1.153 The lack of record keeping concerning the business of the Board was a violation of the Act, which said:

> *A credit union shall prepare and maintain, at its registered office, or subject to subsection (2), at any other place in New Brunswick designated by the directors, records containing*
>
> *(a) copies of the articles and the by-laws and all amendments to them,*
>
> *(b) the duly executed minutes of meetings and resolutions of members,*
>
> *(c) a register of directors, officers and committee members setting out the names, residence addresses and principal occupations, if any, of all persons who are or have been directors, officers or committee members of the credit union with the several dates on which each became or ceased to be a director, officer or committee member,*
>
> *(d) a members register setting out the names and the latest known addresses of its members and the number and issue price of the membership shares held by each member, and*
>
> *(e) the accounting records and the duly executed minutes of meetings and resolutions of the directors and any committee appointed by the directors.*

1.154 And

> *A copy of every resolution referred to in subsection (1) shall be kept with the minutes of the proceedings of the directors or of a committee appointed by the directors.*

Board correspondence

1.155 KPMG's interviews with former Board members identified that mail from CUSF/RMA or the Superintendent that was addressed to the Board or a Board member would be sent to the LCPS head office, where it would be opened by senior management who would draft a response before the letter was discussed by the Board. The CUSF/RMA letters were not always provided to the President or the Board.

1.156 One Board member was concerned that not all mail addressed to the Board member was delivered to the Board member. This individual eventually met with CUSF/RMA and had correspondence from CUSF/RMA redirected to the individual's home address.

1.157 KPMG was told by one former president that when this former president said it seemed unusual that no correspondence from CUSF/RMA was ever addressed to the President of the Board the response given by the former general manager was that nothing was ever addressed to the President. KPMG did identify that in fact several letters had been addressed to the President.

Salary committee

1.158 Like other Board minutes, KPMG was informed that the minutes of the Salary Committee were retained by one or more members of the former LCPS senior management group, and so various Board members commented that they did not know the salaries of the former senior management group. KPMG was not able to locate any Board policies or procedures relating to salaries. KPMG was told that in the absence of any policies or procedures, the Board placed a high degree of reliance on the recommendations of the former senior management group.

1.159 One specific situation was described to KPMG by a former Board member. In 2000 or 2001, a new long service compensation arrangement was introduced by the former general manager of LCPS. This was intended to provide additional compensation to employees with over ten years' service. No estimate of cost was presented to the Board. This former Board member indicated that, because senior management was covered by the proposed plan, the Board member requested a formal study be done of the plan. This Board member alleges that the plan was then put to an immediate vote and approved. Therefore no additional study was done on the proposal. KPMG could not find any minutes documenting the approval of the plan, although they did identify at least one payment that was subsequently made under the plan.

Introduction of Permanent Investment Shares

1.160 In January 1996, LCPS introduced a new type of investment share called "Les Parts Permanentes d'Investissement" or "Permanent Investment Shares". Former Board members told KPMG that there was little understanding on the part of Board members or discussion by the Board about the offering of these shares prior to approval. One Board member indicated that the initial offering document and the notes to the financial statements were already drafted when the idea was first brought to the Board. KPMG was told that these shares were issued to raise the equity level of LCPS. The offering of these new shares was approved in 1996 by CUSF/RMA and the Office of the Superintendent. KPMG also identified that the investment share registry was not properly maintained.

Lending activities

1.161 Based on their review of some loans, KPMG identified that LCPS' financial analysis of the underlying client data was not complete, and did not identify the extent of the financial risk that LCPS would be exposed to. There was little evidence that, even though required by their own lending policies, the former Board of Directors:

- annually reviewed its loan policy;
- ensured that LCPS had an internal quality review program for its lending activities;
- thoroughly reviewed the results of the periodic inspections by CUSF/RMA or the external audits; or
- reviewed the contents and credit worthiness of the loan portfolio, trends within the portfolio or the associated allowances for doubtful accounts, other than reliance on a cursory overview provided by the former LCPS senior management group.

1.162 Also, through interviews with the former external auditors, KPMG was informed that neither the Board nor its Audit Committee met with the former external auditors without management present. Furthermore, the Board did not ask the former external auditors any questions.

1.163 *In our opinion, while there were some cases where individual members of the Board of Directors tried to properly execute their* *fiduciary duty, the Board as an entity failed to provide the necessary check on management that it should have done, until five members of the Board changed in 2004. The Board essentially acted as an extension of management, and it would appear in some cases that there were enough Board members who were willing to act in this manner that a member or members of senior management were able to operate LCPS with little oversight.*

1.164 *After the Superintendent received a complaint in 2003 about term limits for Board members being exceeded and about voting irregularities, a new Board of Directors had to be elected. In the end it was the actions of the new Board, and the new Board president Ms. Jacqueline Hébert, that halted the management practices that were damaging LCPS financially.*

The auditors and their audits of the financial statements

Background

1.165 During the time period we examined, four different auditors issued opinions on the year-end financial statements of LCPS. These were:

- Grant Thornton (operating as Doane Raymond for part of this time period) for the years ended 31 May 1997 to 31 May 2001;
- Bourque Haché Duguay for the year ended 31 May 2002;
- Duguay Gagnon for the year ended 31 May 2003;
- PricewaterhouseCoopers for the year ended 31 May 2005.

1.166 The auditors did not record any reservations in the audit reports for those years.

1.167 Audited financial statements were not issued for the year ended 31 May 2004. The 2004 results are only available as comparative figures presented in the 31 May 2005 financial statements.

1.168 Grant Thornton resigned as external auditors for LCPS after the 31 May 2001 year end, and the firm of Bourque Haché Duguay was appointed. Duguay Gagnon succeeded Bourque Haché Duguay as external auditors, and René Duguay was the audit partner in both firms responsible for the 31 May 2002 and 2003 year end audits. Duguay Gagnon was disqualified by the Superintendent of Credit Unions from continuing as auditor after the 31 May 2003 year end.

1.169 The rules of professional conduct of the New Brunswick Institute of Chartered Accountants require that, when a member Chartered Accountant is replacing another member as external auditor, the member must communicate with the former auditor enquiring whether there are any circumstances the member should take into account which might influence the member's decision whether or not to accept the engagement.[1] KPMG discussed this requirement with each of the above listed audit firms and were informed that this communication occurred upon each change in auditors. In KPMG's interview with the 2002 and 2003 audit partner, the partner indicated that he was aware of Grant Thornton's reason for resigning the audit assignment. We will discuss this in more detail in this section.

1.170 *In this section we provide information about the audits of LCPS performed by Grant Thornton, Bourque Haché Duguay and Duguay Gagnon. We did not perform any review of the audits done by PricewaterhouseCoopers.*

Grant Thornton

1.171 *In the section of this report on Allowance for Losses reported by LCPS, we provided our estimate of the allowance for the period of time during which Grant Thornton was the external auditor. In that section we concluded that the allowance for losses were understated for the years ended 31 May 1996 until 31 May 2001, although only in one of those years was the understatement in excess of the one million dollar audit materiality that Grant Thornton was using. We further estimated that the value of the assets and equity for LCPS would have been significantly misstated for some of those years.*

1.172 *However, the analysis also shows that it is doubtful that the net income for any of those years would have been affected since management could have entirely offset the impact by changing the amount of patronage rebates recorded.*

1.173 *We believe that had Grant Thornton taken a more skeptical attitude to the explanations provided to them by management of LCPS, and required the recording of a general allowance in addition to the specific allowances recorded by management, they would have concluded that adjustments to the amount of allowance recorded were required.*

1.174 *Earlier in this report we identified three other accounting issues identified by KPMG: netting of account balances; recording of interest revenue on impaired loans; and recording of patronage*

---

1. New Brunswick Institute of Chartered Accountants; *Rules of Professional Conduct*; September 2004; Rule 302.1.

rebates. It appears that one or all of these issues was present during the years that Grant Thornton performed the audit of LCPS.

1.175 *Some factors that support Grant Thornton's conclusion that the financial statements were not materially misstated include the following:*

- KPMG reviewed the working papers of Grant Thornton which contained evidence of computer assisted auditing techniques on loan portfolio files and other items. There was also evidence that Grant Thornton requested confirmation of balances on many accounts. Furthermore, for complex issues Grant Thornton conferred with their professional practice group and documented the rationale for their accounting decisions.

- We saw evidence that Grant Thornton did assess the collectability of some specific commercial loans, including discussing the specific loans with LCPS management and documenting information about the future prospects of those companies.

- The CUSF/RMA inspection reports issued 6 May 1997, 16 December 1998 and 15 May 2000 all agreed with the allowances that management had recorded.

- As part of Grant Thornton's planning for the 31 May 2001 audit, a planning memo was prepared for the Audit Committee of LCPS. Within the memo, Grant Thornton raised proposed changes in the accounting treatment of repossessed assets and the establishment of a general reserve for LCPS' loan portfolio. This memo was reviewed by one or more members of the former LCPS senior management group prior to it going to the Audit Committee. KPMG was informed that a member of the former LCPS senior management group opposed the presentation of the planning memo to the Audit Committee. The memo was eventually presented to the Audit Committee by Grant Thornton, although LCPS management was present at the meeting.

- The issue of requiring a general allowance was never settled by CUSF/RMA. They raised it in their 16 December 1998 inspection report issued to LCPS however they left it to the discretion of LCPS as to the need and the amount of such an allowance. Also, in a letter to Grant Thornton dated 14 May 2001 CUSF/RMA specifically said that CUSF/RMA "…has not as yet reviewed the issue of a *general allowance*. In fact certain CUSF inspection reports have indicated to the related credit union "that the need for, and the size of any *general allowance* is left, at this time to the discretion of the credit union.""

- As stated above, it is doubtful that the net income for any of those years would have been affected since management could have entirely offset the impact by changing the amount of patronage rebates recorded.

1.176 *In the final analysis, it is our opinion that even had Grant Thornton been successful in having the former management group of LCPS increase the allowance for losses, or required adjustments for the other accounting issues we identified, there would not have been enough of an impact to cause any action by the regulators, or change management's eventual course of action.*

1.177 Grant Thornton resigned as external auditors after the 31 May 2001 year end. KPMG interviewed Grant Thornton and were told of two reasons for their resignation. First, there was increasing conflict with one or more members of the former LCPS senior management group on the adoption of emerging accounting rule changes, proposed changes and on the acceptance of proposed journal entries. Also, Grant Thornton felt that one or more members of the former LCPS senior management group's approach to Grant Thornton's staff was abusive.

1.178 *It also appears to us that Grant Thornton was becoming concerned with the approach to recording allowances taken by the former management group of LCPS.*

Bourque Haché Duguay and Duguay Gagnon

Appointment of auditors

1.179 For the year ended 31 May 2002, LCPS appointed Bourque Haché Duguay as auditors. This firm was not on the list of approved auditors maintained by CUSF/RMA. This was the subject of a discussion between LCPS and CUSF/RMA on 30 October 2001. LCPS maintained in a letter written on 31 October 2001 that they had verbal approval from the Superintendent of Credit Unions to use Bourque Haché Duguay.

1.180 In correspondence dated 11 March 2002 CUSF/RMA advised LCPS that pursuant to the "regular meeting of the CUSF/RMA Board of Directors…your request for a change in auditor is not approved…" However, LCPS disagreed with this decision and proceeded with the 31 May 2002 audit with Bourque Haché Duguay as external auditors.

1.181 For the year ended 31 May 2003, LCPS appointed Duguay Gagnon as auditor. This firm was also not on the CUSF/RMA approved list of auditors.

1.182 CUSF/RMA's concerns about Bourque Haché Duguay and Duguay Gagnon acting as auditors were as follows:

- CUSF/RMA was of the opinion that the firms did not have sufficient experience as external auditors of a large financial institution and, given the complexity of auditing a financial institution of the size of LCPS, this was an issue.

- The firms were not on the approved list of auditors maintained by CUSF/RMA.

- The 2002 and 2003 audit partner and his spouse owned LCPS permanent investment shares. According to CUSF/RMA, this share ownership rendered the 2002 and 2003 audit partner not independent.

- The 2002 and 2003 audit partner had also been an employee of LCPS.

1.183 The 2002 and 2003 audit partner actively tried to get Bourque Haché Duguay approved by CUSF/RMA. In correspondence dated 12 June 2002 he applied to the Superintendent to have the Superintendent grant an order exempting Bourque Haché Duguay from disqualification from the approved list of auditors. In this correspondence the 2002 and 2003 audit partner also advised the Superintendent that he owned permanent investment shares of LCPS; however he considered this ownership not to be material, and so not in contravention of the Act.

1.184 Even though CUSF/RMA had taken a firm position on 11 March 2002 – *in time to have a new auditor appointed for the 31 May 2002 audit* - the Superintendent of Credit Unions did not render a decision on the appointment of the auditors until 11 February 2004 – almost two years later. On that date, the Superintendent sent a letter to CUSF/RMA that stated that:

> *I am of the opinion that as a beneficial owner of shares, [the 2002 and 2003 audit partner's] independence is put in question and that he is not independent of the credit union and is, therefore, not eligible for appointment as auditor for*

the Caisse Populaire de Shippagan Limitee on a continuing basis.

1.185 The Superintendent also granted an order exempting the 2002 and 2003 audit partner and the firm Bourque Haché Duguay from disqualification for the purpose of the 2001-2002 and 2002-2003 audits of LCPS, but did not grant an exemption for future years. We comment further on this decision in the section of this report on Regulatory Issues.

Audit issues related to the allowance for losses

1.186 *In our analysis of the allowance for losses reported by LCPS for the period of time during which Bourque Haché Duguay and Duguay Gagnon were the external auditors, we concluded that the allowance for losses was materially understated for the years ended 31 May 2002 and 31 May 2003. We further estimated that the value of the assets and equity for LCPS would have been materially misstated for those years. In contrast to the earlier years, the affect on LCPS' net income of recording the larger allowance could not have been entirely, or even mostly, offset by a reduction in the amount of patronage rebates declared.*

1.187 In the section of this report on Allowance for Losses we also identify that for the 31 May 2003 audit, Duguay Gagnon should have had access to the 10 January 2003 inspection report that not only questioned the amount of the allowance but also outlined some significant risks facing LCPS that should have indicated that the audit of LCPS was of very high risk. When KPMG specifically looked at the planning that was done for the 31 May 2003 LCPS year end, which was completed 7 July 2003, they did not locate any documentation in the working papers of Duguay Gagnon indicating that this was considered in the audit planning.

1.188 *We believe that in the years ended 31 May 2002 and 2003, it should have been clear that the allowance for losses reported by LCPS was materially understated, and the auditors should have recorded a reservation of opinion. We also believe that the extent of the misstatement would have been large enough that it would have been likely that the regulators would have been forced into taking action.*

1.189 KPMG reviewed the working papers of Bourque Haché Duguay and Duguay Gagnon. When reviewing the work done on the allowance, they noticed that some loans that were delinquent were not provided for. For example, one loan with a balance of over

$60,000 was delinquent by 1,539 days and was not provided for. The audit working paper file indicates that this loan was reviewed, but there was no documented reason for excluding it from the allowance for losses. Furthermore, the working papers related to specific loans do not include an indication that the loans were discussed with management, as was evidenced in the Grant Thornton working papers.

1.190 When acting as one of the three members of the arbitration panel assembled by the Court of Queen's Bench to review the amount of the allowance recorded by LCPS at 31 October 2002, the 2002 and 2003 audit partner recommended an increase to the allowance. Based on the specific loans looked at by the panel, the 2002 and 2003 audit partner recommended an increase that equaled 80% of CUSF/RMA's recommended amount. *This implies that he was able to look at the October allowance and come to the conclusion that LCPS had under-recorded it by at least $2.9 million. However when issuing his audit opinions for both 2002 and 2003, he accepted management's allowance without adjustment.*

Other issues

1.191 In spite of all of the circumstances pointing to a high risk audit, and CUSF/RMA's findings that both the method of determining the allowance and the amounts of the allowance at specific points in time were significantly insufficient, the auditors used a materiality level for both the 2002 and 2003 year ends that was twice the materiality level used by Grant Thornton in 2001, and could have resulted in fewer audit tests being applied.

1.192 Earlier in this report we identified some other accounting issues at LCPS. In KPMG's review of the working papers of Duguay Gagnon, they did not see evidence of proper evaluation by the auditors of these issues which were: netting of account balances; recording of interest revenue on impaired loans; and recording of patronage rebates.

Regulatory issues

1.193 *In hindsight, there were many opportunities where, had rigorous regulatory intervention occurred, the eventual losses incurred at LCPS could have been avoided or at least minimized. However for that intervention to have happened there had to have been a level of resolve on the part of the Superintendent that was not displayed when it became clear beyond any reasonable doubt that action was needed.*

1.194 *The ability of a regulator to take meaningful action would be subject to the powers given to the regulator by legislation. In this way, CUSF/RMA had limited ability to act. CUSF/RMA could issue orders or directives, but LCPS had the power to appeal those to the Superintendent, and further to court. CUSF/RMA could pass a resolution to place a credit union under supervision, but only the Superintendent could actually give effect to that resolution. This placed CUSF/RMA in the frustrating position of trying to get action taken, but having to wait for the Superintendent to decide whether or not to take the action. It is also possible that the Superintendent could have been faced with legal obstacles in the way of taking action.*

1.195 *We believe that if government is going to put in place regulations that must be adhered to, and put in place bodies to see that those regulations are adhered to, then government should give the regulators the means as well as the obligation to act swiftly.*

1.196 *The first obvious decision point was almost thirty years ago.* From its inception in 1937 until 1981, LCPS was a member of la Fédération des caisses populaires acadiennes (FCPA). However, after a series of disagreements between FCPA and the management of LCPS, LCPS moved to CUCNB. In an internal government of New Brunswick memo dated 9 December 1980, addressed to the Minister responsible for credit unions, the writer said:

> *…the affiliation with the Credit Union Central of New Brunswick is the only alternative at this time; from recent discussions with representatives of the Acadian Federation it was indicated that matters were such that it could very well be that Shippagan Credit Union would have been asked to leave the Acadian Federation; if such had occurred, under the present Credit Union Act, the Credit Union would have had difficulty in continuing to operate as a Credit Union since it would not have been affiliated to any Federation.*

1.197 *In hindsight, the particular problems which later occurred at LCPS could have been avoided had the government at the time taken the position that either management of LCPS complies with the Acadian Federation or that the management would be replaced. Regardless, it was obvious as far back as the 1980s that LCPS management had issues with regulatory oversight.*

1.198 *In the time period we looked at, the next point of possible intervention would have been the dispute over the need to adhere to section 5(a) of the Regulations. CUSF/RMA raised this issue as part of its 6 May 1997 inspection report, but the issue was not resolved. We would have thought that failure to adhere to mortgage lending limits set by law should be seen as a serious breach of conduct. However, the issue continued to escalate. That escalation should have been sufficient for CUSF/RMA to recommend supervision, or for the Superintendent to step in and place LCPS under supervision. For example, LCPS' threat to take the dispute to court, despite what CUSF/RMAs legal advisors evaluated to be a weak position, could have been a trigger, or certainly the 23 June 2000 LCPS Board resolution to withdraw its membership from CUCNB could have been.*

1.199 *It appears that while CUSF/RMA was performing detailed inspections throughout this time period, the actions they took were not as serious as the inspection results would have suggested. In particular the inspection report issued 16 December 1998 should have resulted in a requirement for prompt improvements with a threat of serious consequences if those improvements were not made. Similarly the inspection report issued 26 October 2001 should have resulted in more serious action. It was not until the 10 January 2003 inspection report that CUSF/RMA was at the point of demanding improvements. In fact CUSF/RMA referred to the situation at that time as grave. It was not until 2 June 2004 that the Superintendent finally granted supervisory powers to CUSF/RMA.*

1.200 *Another possible point of intervention would have been the resignation of Grant Thornton as auditors following the 31 May 2001 year end. It appears from the fact that CUSF/RMA sent a copy of the 26 October 2001 inspection report to Grant Thornton that they were not immediately aware of the resignation. The resignation of an auditor is a very serious matter and CUSF/RMA should not have had to ask permission from LCPS to talk to the auditors about the resignation; they should have that power under their legislation. LCPS' abusive attitude toward Grant Thornton staff should have been cause for at least some form of temporary supervision until CUSF/RMA could be satisfied of the circumstances around the resignation.*

1.201 *Similarly, the appointment of an auditor who was not on the CUSF/RMA approved list of auditors should have been sufficient to immediately have an approved auditor put in place or to put LCPS* *under supervision. Explanations about verbal approvals should not have been entertained. It does appear that CUSF/RMA recognized this and tried to rectify the situation. In March 2002 they advised LCPS that LCPS had to put in place an approved auditor. Unfortunately they could not force this situation on their own; they required the support of the Superintendent. The Superintendent took until February 2004, almost two years, to make a decision.*

1.202 *In the February 2004 decision, we believe that the Superintendent was absolutely right to point out that it was the "nature of the permanent investment shares" rather than the small percentage of the auditor's ownership of those shares that would put the auditor's independence in question. We also agree with the Superintendent's decision that:*

> *I am of the opinion that as a beneficial owner of shares, [the 2002 and 2003 audit partner's] independence is put in question and that he is not independent of the credit union and is, therefore not eligible for appointment as auditor for the Caisse Populaire de Shippagan Limitée on a continuing basis.*
>
> *While I have based this finding on the situation both at the time of appointment by the caisse and at the time of [the 2002 and 2003 audit partner's] appointment, I must also observe the changes that have been occurring and will occur in the coming months in the accounting profession's Code of Conduct.*
>
> *The accounting profession and public now demand and will in future demand a much higher level of accountability and independence in its Boards and in its auditors.*

1.203 *Unfortunately this decision was made too late for it to have reduced the extent of the losses that eventually occurred – coming two years after CUSF/RMA had taken its firm position on the matter.*

1.204 *The rest of the Superintendent's decision is disappointing, it says:*

> [The 2002 and 2003 audit partner] *was appointed auditor for the Caisse Populaire de Shippagan Limitée at its Annual General Meeting for the 2001-2002 and 2002-*

2003 fiscal years. The fiscal year-end for Shippagan is May 31.

I can only assume that [the 2002 and 2003 audit partner's] *appointment as auditor was made in good faith by the members of the credit union, and without the knowledge that* [the 2002 and 2003 audit partner] *was not on the list of approved auditors of the Stabilization Board.*

I am, therefore, prepared to grant an order exempting [the 2002 and 2003 audit partner] *and the firm Bourque Haché Duguay from disqualification for the purpose of the 2001-2002 and 2002-2003 audits of the Caisse Populaire de Shippagan Limitée, that is, for the period from the 2001 Annual General Meeting of that caisse until the 2003 Annual General Meeting.*

I am not prepared, for the reasons outlined above, to grant an exemption for future purposes as I am not satisfied that an exemption would not unfairly prejudice the members of the Caisse Populaire de Shippagan Limitee.

1.205 *In our opinion the final decision is confused. If the Superintendent was going to assume that the members of LCPS acted in good faith in appointing the 2002 and 2003 audit partner as auditor, the Superintendent should also have assumed that neither management nor the Board of LCPS had told the members that neither the 2002 and 2003 audit partner nor his firm were on the approved list of auditors; or that CUSF/RMA had specifically ruled them to be ineligible to perform the audit; or that the 2002 and 2003 audit partner had a conflict because of his ownership of a level of LCPS permanent investment shares that provided him with a significant level of income. An audit is intended to provide those same members with an independent examination of the financial results and position of the enterprise. The Superintendent recognized that those members could be unfairly prejudiced by the 2002 and 2003 audit partner's continuing to be the auditor in the future. The decision should have been to recognize that there was risk to the members of LCPS for the 31 May 2002 and 31 May 2003 fiscal years precisely because they acted in good faith in appointing the 2002 and 2003 audit partner. The Superintendent should have ordered immediate supervision to sort out what had occurred in those two years. Placing LCPS under supervision at this point would not have* *avoided much of the eventual loss, since LCPS was put under supervision four months later.*

1.206 *The point here is that the Superintendent made the right decision in disqualifying the 2002 and 2003 audit partner, but should have made that decision sooner. CUSF/RMA tried to get the Superintendent to act more quickly. In particular on 27 June 2002 CUSF/RMA sent a letter to the Superintendent asking for a decision about LCPS' appeal of CUSF/RMAs disqualification of the auditors. Other letters on this issue were sent on 13 May 2003 and 30 May 2003. Finally on 30 January 2004, CUSF/RMA wrote to the Superintendent demanding a decision on the auditor issue. During this time period, the Superintendent was not idle, for example a request was made on 31 July 2002 to the New Brunswick Institute of Chartered Accountants looking for information about the rules of conduct for chartered accountants that should be used in assessing auditor independence.*

1.207 *During this time period it was common for the Superintendent to take an excessive amount of time to render a decision. On 21 March 2003, CUSF/RMA informed the Superintendent that it had passed a motion to place LCPS under supervision effective immediately. It took ten months before the Superintendent denied the request. Also, CUSF/RMA had issued ten orders to LCPS on 16 January 2003 and it took the Superintendent eleven months to rule on those orders.*

1.208 *KPMG did identify one situation where the Superintendent acted in an appropriate time frame, as discussed in the Governance section of this report. That involved a complaint written on 3 October 2003 about irregularities at the LCPS annual general meeting, and by 22 December the Superintendent had ruled that changes LCPS had made to their by-laws were not in accordance with the Act.*

1.209 *We understand that in 2002 and 2003, since the Superintendent had been performing the role part time, the Department of Justice had directed that other matters unrelated to LCPS were paramount. This highlights that the ability of the Superintendent to act is not just dependent upon the individual in the role, but also the Deputy Minister and Minister to whom the Superintendent reports.*

1.210 *One other possible point of intervention would have been if LCPS had reported a large loss for the fiscal year ended 31 May*

2002, as our analysis in the section on Allowances for Losses suggests should have been reported, or if the external auditor had recorded a reservation in the audit opinion for that year. Unfortunately neither of these events happened because of the inadequacies of the external audit.

1.211 *Despite everything that had occurred at LCPS, it was eventually only put under supervision at the request of the new LCPS Board. The people on this new Board of Directors who voted for action were the ones with the courage to recognize that things were not right at LCPS and had to change. On 31 May 2004 Ms. Jacqueline Hébert, President of the LCPS Board, wrote to CUSF/RMA requesting supervision. We understand that Ms. Hébert had been advised of the findings in the Marcil Lavallée report and had approached CUSF/RMA expressing concerns about the findings in the report. This report was discussed at a 1 June 2004 meeting between the LCPS Board and CUSF/RMA.*

1.212 *It appears to us that the Superintendent tried to take an even-handed approach in deciding whether to approve supervision for LCPS, resulting in a prolonged decision period. We don't believe that the role of the Superintendent was, or should be as an even-handed arbiter. The Superintendent should have had a bias toward protecting the members of LCPS and toward protecting the Province's guarantee of the deposits at LCPS. Such an approach would have meant granting the supervision request of CUSF/RMA and sorting through the details afterward. Part of the problem was that the Superintendent did not have any procedures or precedents to follow in determining the appropriate course of action.*

1.213 *The system safeguard that ended up working was the limit on Board member terms which was brought to the Superintendent's attention not through inspections or other regulatory action, but because of a written complaint by a member of LCPS concerning the 2003 Board elections. This led to the Superintendent's decision of 22 December 2003 that five members of the Board had exceeded their nine year consecutive term limit and ordering immediate steps to remedy this situation.*

1.214 *Eventually, the Province paid LCPS about $31 million and provided L'Office de stabilisation de la Fédération des caisses populaires acadiennes limitée an interest free loan of almost $10 million upon the transfer of LCPS back to FCPA. The terms of this interest free loan make it equivalent to a grant of about $6 million.*

The total direct cost of stabilization funding to New Brunswick taxpayers to date resulting from the Province's intervention at LCPS is therefore about $37 million. In KPMG's interview with representatives of CUSF/RMA, they expressed the view that about $20 million of the eventual losses could have been avoided had supervision been granted as a result of the 2002 inspection report. We agree that this is a reasonable estimate.

1.215 *We also believe that more serious actions should have been recommended as a result of earlier inspection reports, which if acted upon could have reduced or even avoided the eventual loss – assuming the Superintendent had acted on such recommendations. KPMG noted that the quality of documentation retained by CUSF/RMA improved from 1997 to 2002 and that in 2000 it was obvious that they had a heightened awareness of the direction that LCPS was taking in terms of non-compliance with the Act and Regulations. Furthermore, CUSF/RMA's inspection process shifted to an enterprise risk management focus and the scope of the inspections increased from 1997 to 2002. It appears that either through decisions of the Superintendent, decisions of the court or independent reports such as the one conducted by Marcil Lavallée, most of CUSF/RMA's findings were ultimately validated.*

1.216 *Ultimately the government's regulation of LCPS failed. It failed as early as 1981 with the decision to allow LCPS to move to Credit Union Central; it failed to properly interpret the symptoms of serious trouble that it had before it in the late 1990s and early 2000s; and it failed to take appropriate action even when the organization responsible for inspections realized the gravity of the situation.*

Recommendations

1.217 The Minister of Finance requested our "…opinion on how to better prevent this type of exposure in the future." In 2008 the Department of Justice made some amendments to the Credit Unions Act; also, in recent Reports of the Auditor General, we made recommendations concerning the operations of both the New Brunswick Credit Union Deposit Insurance Corporation and the Office of the Superintendent. The changes that have been made have resulted in some improvements that will help to prevent a reoccurrence of the LCPS events.

1.218 We have six recommendations. Some of them may already have been addressed by recent changes to the Legislation or to the regulatory bodies, but the Department of Justice and Consumer Affairs should review those issues again to make sure that the current regime is robust enough to detect or prevent reoccurrences of the LCPS events.

1.219 We recommend the Department of Justice and Consumer Affairs ensure that the current requirements of Sections 242 and 242.1 of the *Credit Unions Act* are sufficient to ensure that a credit union can only transfer from one federation and the stabilization board established in relation to that federation to the other federation and the stabilization board established in relation to that federation if the underlying circumstances warrant the transfer.

1.220 We recommend the Department of Justice and Consumer Affairs ensure that the *Credit Unions Act* places both the power to inspect a credit union and the power to put a credit union under supervision in the same organization.

1.221 We recommend the Department of Justice and Consumer Affairs ensure that Section 246(3) of the *Credit Unions Act* is sufficient to ensure that a credit union that has been placed under supervision is in fact under supervision during any appeal process.

1.222 We recommend the Department of Justice and Consumer Affairs ensure that the *Credit Unions Act* gives the Superintendent of Credit Unions sufficient power to ensure that only auditors with the requisite skills, experience and independence are appointed auditors of credit unions.

1.223 We recommend the Superintendent of Credit Unions be independent of the Department of Justice and Consumer Affairs, and have the resources needed to properly supervise the credit union system.

1.224 We recommend Executive Council ensure that term limits exist for all members of the governing bodies of provincial Crown corporations, agencies, boards and commissions. If existing members of governing bodies have been in place for a long period of time, there should be a transition plan to replace them. The length of the transitional period should be inversely proportional to the length of time the board member has served.