

## **MEMBER ONE FEDERAL CREDIT UNION SUPERVISORY COMMITTEE**

**SUBJECT:** Response to Advanced Notice of Proposed Rulemaking – 12 C.F.R., Parts 704, 715, and 741

**QUESTION 1.** Should part 715 require, in addition to a financial statement audit, an “attestation on internal controls” over financial reporting above a certain minimum asset size threshold? Explain why or why not.

Response: Yes. Aside from showing a willingness to meet the standards required by its competitor financial institutions, credit unions would improve their operations by requiring their Board to formally assess the effectiveness of their internal control structure and the procedures in place to maintain adequate internal controls. Although Boards of large financial institutions are often very experienced in the primary operations of their “profit making” departments, the same may not be true of less noticeable and/or non-income producing operations, including internal control departments. Management often is more willing to limit resources for internal controls since they are not profit driven and most Boards are heavily influenced by their management teams. A requirement for a formal review that must be attested to by independent auditors would balance the scales in this ever increasingly important area.

**QUESTION 2.** What minimum asset size threshold would be appropriate for requiring, in addition to a financial statement audit, an “attestation on internal controls” over financial reporting, given the additional burden on management and its external auditor? Explain the reasons for the threshold you favor.

Response: NCUA should be consistent with other regulatory agencies in this area. However, they also should consider the types and complexity of operations in which credit unions engage. Thus, if a credit union is a full service organization that presents unusual risks to the credit union’s continued successful operation or undue risk to the National Credit Union Administration Insurance Fund (NCUSIF), a requirement should be made for compliance regardless of size.

As an aside, although a financial statement audit is only required of credit unions with \$500 million in assets, most credit unions of any size have a financial statement audit completed. Given the value of the attestation to the overall management of an institution, it would not be long before most credit unions would voluntarily follow suit.

**Question 3.** Should the minimum asset size threshold for requiring an “attestation on internal Controls” over financial reporting be the same for natural person credit unions and corporate credit unions? Explain why.

Response: Yes, with the proviso that any corporate with complex operations by corporate standards be required to comply with the attestation procedures.

Question 4. Should management's assessments of the effectiveness of internal controls and the attestation of its external auditor cover all financial reporting (i.e., financial statements prepared in accordance with GAAP and those prepared for regulatory reporting purposes), or should it be more narrowly framed to cover only certain types of financial reporting? If so, which types?

Response: Compliance should be required especially for regulatory reporting. With advances in technology and the ability to analyze a credit union's financial condition through electronic monitoring, it is critical that the data be accurate. Not only will electronic monitoring help to ensure the safety of the credit union industry, it will also aid in reducing the supervisory costs within NCUA.

Question 5. Should the same auditor be permitted to perform both the financial statement audit and the "attestation on internal controls" over financial reporting, or should a credit union be allowed to engage one auditor to perform the financial statement audit and another to perform the "attestation on internal controls?" Explain the reasons for your answer.

Response: Our initial "gut" response is both can be accomplished by the same firm. First, we believe the added responsibility to do the attestation will help improve the quality of the financial statement audit, if necessary. The added liability of making an error when responsible for both would be awesome. Not many firms would fail in both areas given the difficulty in proving they should not have realized deficiencies occurred after doing two reviews. Second, we have concerns that credit unions would get in the middle of two firms fighting over the adequacy of the internal control department to protect the integrity of the financial statement. However, if NCUA found situations that presented a risk to credit unions or the (NCUSIF), we believe a requirement to have a separate firm complete the attestation would be warranted.

Question 6. If an "attestation on internal controls" were required of credit unions, should it be required annually or less frequently? Why?

Response: Annual attestations should be required only under two circumstances: a) there are problems with the accuracy of the financial statements or the ability of internal controls to identify problems, and b) there are major changes or a reorganization within an internal control department. That aside, the limit should be no less frequently than every three years with the proviso that the credit union must consult yearly with the firm that last performed the attestation to determine if circumstances warrant an annual attestation.

Question 7. If an "attestation on internal controls" were required of credit unions, when should the requirement become effective (i.e. in the fiscal period beginning after December 15 of what year)?

Response: We are unclear of the intent of this question.

Question 8. If credit unions were required to obtain an “attestation of internal controls,” should part 715 require that those attestations, whether for a natural person or corporate credit union adhere to PCAOB’s AS 2 standard that applies to public companies, or to the AICPA’s revised AT 510 standard that applies to non-public companies? Please explain your preference.

Response: Generally, the standards adopted should be consistent with those adopted for credit union peers – other financial institutions. Given that the AICPA is revising AT 501 to be more in line with PCAOB’s Auditing Standard No.2 (AS 2), it would appear that the AT 501 once revised would be more directed to non-public organizations such as credit unions.

Question 9. Should NCUA mandate COSO’s Internal Control – Integrated Framework as the standard all credit unions must follow when establishing, maintaining and assessing the effectiveness of the internal control structure and procedures, or should each credit union have the option to choose its own standard?

Response: Without knowing what other standards are available and given the importance of the issue, we would opt with the established COSO standards.

Question 10. Should Supervisory Committee members of credit unions above a certain minimum asset size threshold be required to have a minimum level of experience or expertise in credit union, banking or other financial matters? If so, what criteria should they be required to meet and what should the minimum asset size threshold be?

Response: Before NCUA considers the extremely complex issue of determining what standards should be required of a “volunteer” supervisory committee, we believe they should review options to the need for a committee at all. Fact is NCUA should consider allowing a credit union to determine if it wants to do away with the volunteer supervisory committee in lieu of an internal audit department, similar to the decision it made a number of years ago in authorizing credit unions to have or not have a loan committee.

Credit unions operations are more complex than every. A perfect supervisory committee would need a combination of lending, accounting, auditing, investment, information system, and asset liability management skills. This does not even include the regulatory compliance skills to fight terrorism and drug traffic currently being emphasized.

Bottom line is the days of volunteer supervisory committee members with the experience to accomplish what needs to be done are nearing the end of the line if not already there. Even with some experience, the task of a new Supervisory Committee member joining a well operated committee and being effective within a reasonable period of time is daunting. Most volunteers, once they learn the difficulties they face, make their tenure short lived.

The idea of a volunteer supervisory committee to protect the assets of the members is antiquated. No other industry has the same concept. Thus, NCUA should direct its

attention to having credit unions develop paid, experienced, and effective internal audit departments. Between its regulatory review and an independent attestation of internal control review, this could be accomplished more effectively than by trying to improve the experience of the committee.

Question 11. Should Supervisory Committee members of credit unions above a certain minimum asset size threshold be required to have access to their own outside counsel? If so, at what minimum asset size threshold?

Response: We have no reason to justify the need for a separate counsel. If NCUA has concerns it would like to share with us in a proposed rule, we would be gladly reconsider.

Question 12. Should Supervisory Committee members of credit unions above a certain minimum asset size threshold be prohibited from being associated with any large customer of the credit union other than its sponsor? If so, at what minimum asset size threshold?

Response: Rather than prohibiting a member of the Supervisory Committee from being associated with large customers, it may be better to require committee members to disclose to the Board potential conflicts of interest and require the Board to establish ethical standards including when committee members must abstain from participating in issues that affect the party to which they are associated. However, if NCUA has specific concerns it would like to share in a proposed rule, we would be gladly reconsider.

Question 13. If any of the qualifications addressed in questions 10, 11 and 12 above were required of Supervisory Committee members, would credit unions have difficulty in recruiting and retaining competent individuals to serve in sufficient numbers? If so, describe the obstacles associated with each qualification.

Response: We fail to see how requiring that the committee have a separate attorney (Question 11) would affect attracting or retaining Supervisory Committee members, unless the Committee member was employed by the legal counsel. However, we believe the qualifications discussed in Questions 10 and 12 would.

Member One is a \$350 million full service credit union. The Board has been trying to attract Supervisory Committee members to fill two of its five positions for more than three years. During that time two members were appointed and three resigned. During the last year, the committee has been studying the expansion of its internal auditing staff from one part-time employee to a full time staff. There is significant work involved in this project alone. Numerous other issues have been addressed during that time period. Most of the work is done by the committee as the paid part-time internal auditor's plate is full. Fortunately, all on the committee are retired, thus allowing them time to participate. It might be virtually impossible to attract members who are working full time. Depending on what qualifications would be regulated, it is likely that only one of our current committee would qualify. Yet members with good management background and

common sense are able to identify issues, draw the right conclusions, and effectively take action.

Question 14. Should a State-licensed, compensated auditor who performs a financial statement audit and/or “internal control attestation” be required to meet just the CPA’s “independence” standards, or should they be required to also meet SEC’s “independence” requirements and interpretations? If not both, why not?

Response: Consistent with previous positions, we believe that NCUA regulations should be consistent with those of other financial institution regulators.

Question 15. Is there value in retaining the “balance sheet audit” in existing Section 715.7(a) as an audit option for credit unions with less than \$500 million in assets?

Response: Unless NCUA is convinced that all credit unions have the expertise on the Supervisory Committee to complete a financial audit or to employ an auditor to do one, there probably is a need to retain the ability to do a “balance sheet audit.”

Question 16. Is there value in retaining the “Supervisory Committee Guide audit” in existing Section 715.7(c) as an audit option for credit unions with less than \$500 million in assets?

Response: Unless NCUA is convinced that all credit unions have the expertise on the Supervisory Committee to complete a financial audit or to employ an auditor to do one, there probably is a need to retain the ability to do a “Supervisory Committee Guide audit.”

Question 17. Should part 715 require credit unions that obtain a financial statement audit and/or an “attestation on internal controls” (whether as required or voluntarily) to forward a copy of the auditor’s report top NCUA? If so, how soon after the audit period-end? If not, why not?

Response: We are sure that most credit unions are more than willing to provide examiners with copies of their audits and attestations on internal controls when asked. Since NCUA’s examinations are fairly regularly scheduled ahead of time, there does not appear to be a benefit to sending them to NCUA which would then have to distribute them to examiners who may not need to review them for an extended period of time. The simplest way to provide the reports to NCUA is to have the examiner request the reports (usually in conjunction with an examination or supervisory visit) and have the credit unions either make them available for the examiner to review in the credit union or forward them directly to the examiner.

Question 18. Should part 715 require credit unions to provide NCUA with a copy of any management letter, qualification, or other report issued by its external auditor in connection with services provided to the credit union? If so, how soon after the credit union receives it? If not, why not?

Response: Our response for providing NCUA with management letters, qualifications, or other reports by external auditors is the same as to question 17.

Question 19. If credit unions were required to forward external auditors' reports to NCUA, should part 715 require the auditor to review those reports with the Supervisory Committee before forwarding them to NCUA?

Response: Since the Supervisory Committee is hiring the external auditor, it is inconceivable that a report would be prepared without the committee being advised of its content, usually at an exit briefing, and receiving the official copy of the report. There should be no need to regulate this area.

Question 20. Existing part 715 requires a credit union's engagement letter to prescribe a target date of 120 days after the audit period-end for delivery of the audit report. Should this period be extended or shortened? What sanctions should be imposed against a credit union that fails to include the target delivery date within its engagement letter?

Response: We believe the target date of 120 days is adequate and should be retained. We also do not believe sanctions are necessary. Most credit unions use the same auditors who are aware of the requirement. In the event a new auditing firm is used and the requirement is not met, usually an exception taken during the examination should correct the error.

Question 21. Should Part 715 require credit unions to notify NCUA in writing when they enter into an engagement with an auditor, and/or when an engagement ceases by reason of the auditor's dismissal or resignation? If so in cases of dismissal or resignation, should the credit union be required to include reasons for the dismissal or resignation?

Response: No! It is our understanding that new auditors are required to contact previous auditors to discuss previous audits and it is the responsibility of the previous auditor to advise the new auditor of problems that led to the dismissal or resignation. If a credit union dismisses an auditor who refuses to engage in misleading or inappropriate reporting of the credit union's activities, does NCUA expect that credit union to tell the agency of its decision?

Question 22. NCUA recently joined the final Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters, 71 FR6847 (Feb. 9, 2006). Should credit union Supervisory Committees be prohibited by regulation from executing engagement letter that contain language limiting various forms of auditor liability to the credit union? Should Supervisory Committees be prohibited from waiving the auditor's punitive damage liability?

Response: We have no objection to NCUA regulating the two areas noted.