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April 19, 2006

Ms. Mary Rupp, Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, Virginia 22314-3428

Re: Comments on Part 715 ANPR, Supervisory Committee Audits

We are a certified public accounting firm of approximately 45 CPAs. We audit the annual financial statements of state and federal chartered, federally insured credit unions ranging in size from $3 to $600 million in assets. In addition, we perform agreed-upon procedures for federal chartered and insured credit unions in accordance with the NCUA's Supervisory Committee Guide. We appreciate the opportunity to comment on NCUA's advance notice of proposed rulemaking regarding Part 715, Supervisory Committee Audits and Verifications.

Questions #1-3 – 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? What minimum asset size threshold would be appropriate? Should the minimum asset size threshold be the same for natural person credit unions and corporate credit unions?

> The Federal Deposit Insurance Corporation Improvements Act (FDICIA) has imposed this requirement on FDIC insured financial institutions (whether publicly held or not) with assets in excess of $500 million since 1991. In 2005, the FDIC increased the asset size to $1 billion. A member that has deposits with a federally insured credit union should benefit from similar safety and soundness requirements as a customer that has deposits with a federally insured bank or savings institution. An attestation on internal controls of a credit union is an objective means of obtaining an opinion as to whether internal controls are effective to produce materially accurate financial information. Accordingly, we concur that the NCUA should have requirements that mirror those of the FDIC for large credit unions. We agree with the new $1 billion asset size threshold and believe that the benefits of such an engagement would outweigh the additional costs to a credit union of that magnitude. Further, the requirements should be the same for natural person and corporate credit unions as a significant amount of member transactions are generally settled through a credit union's accounts at a corporate credit union.

In addition, natural person credit unions tend to have significant uninsured deposits with corporate credit unions making effective internal controls over financial reporting for corporate credit unions even more important.

Question 4 – Should management's assessments of the effectiveness of internal controls and the attestation by its external auditor cover all financial reporting, or should it be more narrowly framed to cover only certain types of financial reporting?

All federally insured credit unions with assets over $500 million are required to have a financial statement audit per generally accepted auditing standards (GAAS) by an independent, state-licensed person or firm. Accordingly, the attestation on internal controls engagement for credit unions with assets over $1 billion should cover the financial reporting process over the annual audited financial statements. It is further suggested that Part 715 is amended to state clearly that the audited financial statements are prepared in accordance with generally accepted accounting principles (GAAP).

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?

Yes, the same auditor should be permitted to perform the financial statement audit and the "attestation on internal controls" over financial reporting. The external auditor has developed a strong base of knowledge of credit union operations and corresponding internal controls over financial reporting. The financial statement auditor could easily extend their internal control procedures and testing in order to complete the attestation engagement. Therefore using the same auditor for both services would result in a more effective and less costly engagement.

However, some credit unions have different firms that perform their external financial statement audit versus their "internal audit" procedures throughout the year. Sometimes the "internal audit" procedures are performed under attestation standards of the AICPA for agreed-upon procedures and therefore the firm is considered independent under AICPA standards. In this situation, the firm that is performing the "internal audit" function may actually have a better knowledge of overall internal controls over financial reporting than the firm performing the external financial statement audit. Further, a credit union may feel that hiring a separate firm to perform the attestation on internal controls engagement would give them another perspective and that the additional cost is justified. Accordingly, the credit union should be allowed, but not required, to engage one auditor to perform the financial statement audit and another auditor to perform the attestation on internal controls.

Questions 6 and 7 – If an "attestation on internal controls" were required, should it be required annually or less frequently? When should the requirement become effective?

The "attestation on internal controls" should be an annual requirement as systems, personnel, products and procedures change at a credit union on a continuous basis. Because such an engagement requires a written assertion by management and extensive documentation of internal controls, credit unions should be given an opportunity to create such documentation. Accordingly, the effective date of this requirement should be two years after the issuance of the final ruling.

Question 8 – If credit unions were required to obtain an "attestation on internal controls" should Part 715 require that those attestations adhere to the PCAOB's AS 2 standard that applies to public companies, or to the AICPA's revised AT 501 standard that applies to non-public companies?

The "attestation on internal controls" should adhere to the AICPA's revised AT 501 standard as the exposure draft for the AICPA's standards states that the statements for attestation engagements (AT 501) is being revised "to reflect guidance from the PCAOB's AS 2, that would be applicable and appropriate for examinations of the internal control on nonissuers, and useful to regulated entities, such as financial institutions, insurance companies, and governmental entities". Accordingly, the AICPA's proposed standards reflect the spirit of the requirements under PCAOB's AS 2.

Question 9 – Should NCUA mandate COSO's Internal Control – Integrated Framework as the standard all credit union management 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?

All credit unions should use the same standards to establish effective internal control procedures in order for an auditor to perform an objective evaluation of those internal controls. Since the most commonly recognized standard is currently the COSO report, it should be the mandated standard at this time.

Questions 10 and 13 – 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? Would credit unions have difficulty recruiting and retaining competent individuals?

Financial institutions such as banks and savings institutions generally have paid directors. In addition since their customer base is not limited by a field of membership, they have a larger universe in order to find audit committee members with a minimum level of experience or expertise in credit union, banking or other financial matters.

Credit union supervisory committee members are unpaid volunteers. In addition, a credit union's field of membership could limit the level of experience or expertise that could be drawn upon in order to find qualified committee candidates. These are valid obstacles for having this sort of requirement. Conversely, it is to the credit union's benefit to have such experience or expertise on its Supervisory Committee in order for the committee to fully understand its responsibilities and the financial condition of the credit union. After all it is the responsibility of the directors and officers of each credit union to protect the "safety and soundness" of the institution. The Supervisory Committee is the agent of the board of directors for financial reporting and internal control matters.

We agree with the NCUA's current disqualifications based upon position and not asset size for federal credit unions and these disqualifications should be expanded to all federally insured credit unions. Further, we believe there should be an affirmative requirement in Part 715 that at least **one** member of the Supervisory Committee should have credit union, banking or related financial management experience or expertise. This requirement should be required on any federally insured credit union with assets of $500 million or more. In addition, consideration should be given to reducing this asset size to $100 million or more in five years. This way it would give credit unions the time to recruit for qualified candidates without an undo burden on the institution.

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?

Since the Supervisory Committee is responsible for "ensuring that the board of directors and management of the credit union meet required financial reporting objectives and establish practices and procedures sufficient to safeguard members' assets", there will be times when the committee should have access to their own outside counsel. This is particularly true when fraud is suspected at the board of director or management level. Accordingly, all Supervisory Committees, no matter what asset size of the credit union, should have the ability to have access to their own outside counsel.

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?

Supervisory Committees are relatively small compared to the size of a typical board of directors. Because of the committee's responsibility for the financial reporting and internal control objectives, it becomes increasingly more important that each member of the committee does not have significant "insider" dealings with the credit union. This is the only way the committee can maintain its independence and objectiveness. Accordingly, committee members should be prohibited from being associated with any large customer of the credit union, other than its sponsor. "Large" customer will need to be defined. A suggested definition would be 2% of assets or 10% of gross loans receivable. We believe that requirement should be applicable to all credit unions over $100 million in assets as it is just as important for committee members to be objective for these smaller sized institutions.

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 AICPA's independence standards or, should they be required to also meet SEC's independence requirements and interpretations?

The AICPA's independence standards have been updated to incorporate independence items of the SEC that are applicable and appropriate for nonissuers and regulated entities, such as financial institutions. Accordingly, we believe that a state-licensed, compensated auditor should be required to meet only the AICPA's independence standards when performing a financial statement audit and/or internal control attestation engagement for a credit union. Setting a dual standard for larger credit unions would cause confusion with very little benefit.

Currently, Part 715.9(a) states that "a compensated auditor who performs a Supervisory Committee audit shall note be related by blood or marriage to any management employee, member of either the board of directors, Supervisory Committee or the Credit Committee, or loan officer of that credit union". In this section, it is unclear as to whether a "Supervisory Committee" audit includes a external financial statement audit performed by state-licensed persons or firms. Further, some of the relationships mentioned, such as "loan officer" are more restrictive than those relationships that are prohibited under the independence standards of the AICPA. This makes the requirements very confusing. As stated above, the AICPA's independence standards should be followed for all financial statement audits and/or internal control attestation engagements for a credit union. Any further restrictions on individuals related to officials should be made clearly applicable only to other Supervisory Committee options for credit unions of less than $500 million in assets.

Question 15 – Is there value in retaining the "balance sheet audit" in existing Sec 715.71 as an audit option for credit unions with less than $500 million in assets?

Should a credit union change from a report on examination of internal control over call reporting or from an audit per the Supervisory Committee Guide to a financial statement audit, the "balance sheet" audit would be applicable in the first year of the change. For an auditor to give an opinion on the operating statements of the credit union, both the beginning and end of year balance sheets would need to be audited. This would be more costly for a small credit union. Therefore, we suggest that the ruling is changed that a "balance sheet" audit is only acceptable for the first year that a credit union changes from an examination of internal control or a Supervisory Committee Guide audit.

Question 16 – Is there value in retaining the "Supervisory Committee Guide" audit in existing Sec. 715.7c as an audit option for credit unions with less than $400 million in assets.

The Supervisory Committee Guide audit option is very valuable for smaller credit unions as it is generally in narrative and table format when performed as "agreed-upon procedures" by an independent public accountant". Many boards and committee members of small credit unions do not have the expertise to read a financial statement and have a much better understanding of the results of this service. Unfortunately, when the Supervisory Committee itself performs this service, it often loses much of its effectiveness. Most small credit unions do not have supervisory committees with a proper level of experience and expertise in financial matters. Board or management fraud can be very problematic in a small credit union because of the lack of segregation of duties or other compensating internal controls. Accordingly, this audit option should be retained only if performed by a qualified internal auditor or other qualified person as set forth under the current Part 715.7c.

Lastly, for all federally insured credit unions, it is our opinion that a financial statement audit should be required annually for credit unions with assets of $50 million or more. Most credit unions of this size have financial products no less complex than those of larger credit unions. Yet, they often cannot afford a full-time employee that is financially qualified. Accordingly, an annual audit would be very beneficial to them. Further for federally chartered credit unions with assets of $10 million or less, there should be the option of performing a financial statement audit.

Questions 17 and 18 – Should Part 715 require credit unions to forward a copy of the auditor's reports to NCUA? If so, how soon after the audit period-end? Should a copy of any management letter, qualification, or other report issued by the external auditor also be provided to the NCUA?

Federally chartered credit unions should forward the financial statement audit, attestation on internal controls, and any other reports addressed to the Supervisory Committee or Board of Directors of the credit union to the NCUA. Copies should be sent to the NCUA within one hundred-twenty days after the audit period-end.

State chartered, federally insured credit unions already are required to forward their audit reports to the state departments of financial institutions. Accordingly, they should not have the burden of sending them to the NCUA.

Question 19 – Should Part 715 require the auditor to review those reports with the Supervisory Committee before they are forwarded to NCUA?

With many smaller credit unions, the Board of Directors requires the auditor to review the reports with them and they invite the Supervisory Committee to the meeting. Other larger credit unions often have extremely experienced chief financial officers that present the results of the audit to the Supervisory Committee or Board of Directors. Because each case is different, it should not be a requirement for the auditor to review the reports with the Supervisory Committee before they are forwarded to NCUA.

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? Should sanctions be imposed against a credit union that fails to include the target delivery date within its engagement letter?

The 120 day is appropriate and should not be extended or shortened. Sanctions should not be imposed against a credit union unless the 120-day period is not met. Further, there should be a process available to obtain extensions of the 120-day period when there are unusual situations.

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.

Credit unions should not be required to notify NCUA in writing when they enter into an engagement with an auditor or when they decide to change auditing firms. All engagement letters should be maintained on file at the credit union for presentation to NCUA during their examination. If an auditor resigns from an engagement, there should be a requirement to notify the NCUA of the resignation with related reasons for such resignation.

Question 22 – Should credit union Supervisory Committees be prohibited by regulation from executing engagement letters that contain language limiting various forms of auditor liability to the credit union? Should Supervisory Committees be prohibited from waiving the auditor's punitive damages liability?

Our firm previously responded to the FFIEC regarding limitation of liability provisions and certain alternative dispute resolution provisions in external audit engagement letters in a letter dated June 8, 2005. A copy of that response is attached for your use.

The officers of Selden Fox, Ltd. appreciate the opportunity to response to this advance notice. We are available to answer any questions the NCUA might have. Please contact Sharon J. Gregor, Vice President of Accounting and Assurance Services at 630-954-1400.

Very truly yours,

SELDEN FOX, LTD.

Sharon J. Gregor

Sharon J. Gregor
Vice President

attachment

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June 8, 2005

Federal Financial Institutions Examination
Council (FFIEC)
Program Coordinator
3501 Fairfax Drive, Room 3086
Arlington, VA 22226

Re: Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters

Council Members:

We are a certified public accounting firm of approximately 40 CPAs. We audit the annual financial statements of non-public federally insured savings banks (under $500 million) and federally insured credit unions ($3 - $500 million). We appreciate the opportunity to comment on FFIEC's proposal regarding limitation of liability and certain alternative dispute resolution provisions in external audit engagement letters.

OVERALL

Although we understand and appreciate the spirit of your proposal, we believe it may go too far because it implicitly suggests that the responsibility for the "safety and soundness" of the financial institution is shifted from the directors and officers of the institution to the external auditor. While, perhaps not your intent, you risk the directors and officers perceiving that they are off the hook for the safety and soundness of the financial institution as long as the external auditor does not catch them. We believe this sends a dangerous signal to those solely responsible for the veracity of the institution's financial reporting. As you are aware, the external auditor's role is limited to expressing an opinion on the financial institution's historical financial statements.

LIMITATION OF LIABILITY CLAUSES

The proposal states that limitation of liability provisions can impair the external auditor's independence. Have there been studies performed to make this link to independence? The AICPA's Ethics Ruling No. 94 states that the following indemnification clause in an engagement letter **would not impair** a CPA's independence:

> "The client agrees to release, indemnify, and holds us, and …, harmless from any liability and costs resulting from knowing misrepresentations by management."

The request for comment seems to be an *all or nothing* type of proposal. There are many valid business reasons for limitation of liability provisions in external auditor engagement letters with its client. Remember, it is management's responsibility for the financial institution's financial statements, for establishing and maintaining effective internal control over financial reporting and for ensuring that the financial institution complies with the laws and regulations applicable to its activities. The auditor is responsible for conducting the audit in accordance with generally accepted auditing standards. Those standards require that the auditor obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, a material misstatement may remain undetected.

If management knowingly misrepresents significant facts to the external auditor, it is virtually impossible for the auditor to uncover the true facts of a situation. Therefore, we believe that the aforementioned indemnification clause in engagement letters does not impair independence, nor does it present safety and soundness concerns when it is included in an engagement letter.

Further, Rule 404 of Sarbanes-Oxley SEC Rules and Regulations specifically elevate management's responsibility by requiring reports on internal control over financial reporting and their certification of disclosure in Exchange Act periodic reports. In addition, in the state of Illinois, there is legislation making it a crime to lie to your auditor. Thus, if it is a crime, why is the auditor not entitled to civil protection? In legal parlance, the issue is always whether the institution will be bound by the acts of management, in the sense that the entity is in the shoes of management that acted wrongfully and cannot then sue the auditor. The limitation of liability provision in engagement letters is just an extension of this defense.

FFIEC's proposal seems contrary to the emphasis being placed on enhanced management's responsibility. The bottom line is if management knowingly lies to the external auditor, the external auditor should not be held liable for any liability or costs caused by those knowing misrepresentations of management. Management is in a position, on a daily basis, to adopt polices and procedures to enhance internal controls, to promote the safety and soundness of the financial institution and to ensure the accuracy of its financial statements. Auditors perform audit tests only once a year and management's representations are an important part of those audit procedures.

Management's ethical tone at the top; its sound judgment and competence; separation of duties, and strict internal controls are the primary safeguards against material errors and fraud. Management, not the external auditor, can control these factors. The elimination of the limitation of liability clauses from engagement letters could make management believe that they can rely on the external auditor to *insure* against material errors or fraud. This certainly does not promote the safety and soundness of a financial institution.

Conclusion Regarding Liability to Clients – We question why the FFIEC wishes to interfere with a financial institution's freedom of contract rights. The price of the audit will always reflect the responsibility of management and exposure to the auditor. Therefore we believe, a properly drafted limitation of liability clause should be allowed in audit engagement letters where the auditor could only be held liable for negligence in performing the financial statement audit and that negligence actually caused the client loss from damage. The auditor should be allowed to limit their liability when knowing misrepresentations of management contributed to the loss.

Conclusion Regarding Liability to Third Parties – Again, we question why the FFIEC would be concerned with an institution's decision to limit exposure of the auditor to claims made by third parties. The cost of the audit should be commensurate with the exposure to risk. Therefore, limitation of liability to third parties should also be allowed if the audit was performed without the external auditor's knowledge that the client intended for a third party to rely on the financial statements, and without the third party actually relying on the financial statements being audited.

ALTERNATIVE DISPUTE RESOLUTION (ADR) AGREEMENTS AND JURY TRIAL WAIVERS

The applicability of the proposal regarding ADR agreements is unclear. Most states have held that sound public policy encourages the use of ADR procedures. In an era where courts are encouraging and mandating ADR procedures, there is no support for the proposition that they are objectionable. Further, pre-trial mediation does not impair the rights of the audited financial institution but rather makes a serious effort to resolve or at least understand differences before going through litigation and thus saves costs for all parties concerned. Accordingly the use of properly crafted ADR agreements should be encouraged. If FFIEC believes that *limitation of liability* clauses are the issue, the proposal should be modified to point out that limitation of liability clauses could also be found in an ADR agreement with the external auditor. Such clauses can also impact safety and soundness issues that were previously addressed in the proposal.

APPLICABILITY TO ALL FINANCIAL INSTITUTIONS

The proposal makes it clear that the limitation of liability provisions "applies to all financial institutions, whether the financial institution is public or not, and whether the external audit is required or voluntary. "

In essence the proposal would extend SEC regulation to non-public companies. Also, it appears that certain of the conclusions reached in the proposal are even more restrictive that the current SEC regulations. Non-public financial institutions are not subject to the same risks or the same regulations and corporate governance as public financial institutions. For instance, public financial institutions are subject to corporate governance requirements that include specifics relating to the responsibilities of board of directors, audit committees and the interaction that each committee member must have. In addition, public financial institutions and their management that misrepresent financial information are subject to enforcement authority of the SEC. No similar enforcement exists for nonpublic financial institutions. Applicability to all institutions will subject all to increased costs of compliance, which may not be warranted given the economic position of an institution.

State-chartered credit unions currently have the opportunity of being privately insured rather than federally insured. Accordingly, they are not subject to the rules and regulations of the National Credit Union Administration (NCUA). If the provisions of this document are adopted, state-chartered credit unions might consider private insurance to avoid the issue and possible increase in audit fees resulting from the elimination of limitation of liability clauses in engagement letters.

OUTSTANDING ENGAGEMENT LETTERS

We disagree that any outstanding engagement letters should be modified to reflect the conclusions of this proposal. Any final provisions should be applied on a prospective basis only. Under the proposed discussion, it is possible that an institution would try to renegotiate an agreement for a service that has already been (or is substantially) completed during 2005. The external auditor has prepared and accepted a fee estimate based on the original negotiated terms and analysis of risk. Modifying outstanding engagement letters would breach a contract with the external auditor; requiring reconsideration of the fee estimate on short notice.

INCREASE IN AUDIT FEES/REFUSAL OF ENGAGEMENT

External auditors should not be viewed as insurance policies because the focus of financial veracity should be on the directors and officers of the institution. Perhaps, the focus should not be employing the lowest bidder as auditor, but the most qualified. The removal of limitation of liability clauses would lead to significantly higher audit fees as the risk of performing the audit has significantly increased.

Because of good business practices, we audit many credit unions that are not required to be audited. Any increase in fees as a result of removing limitation of liability provisions would discourage these financial institutions from having an independent financial statement audit. Rather they would have internal supervisory committee examinations by volunteers who have little training in performing such exams. Accordingly this would increase the risk of safety and soundness issues of these institutions.

It is difficult to say whether fewer audit firms would be willing to provide external audit services to these financial institutions. The increase in possible unfounded litigation could certainly discourage CPA firms from providing this service. Any CPA firm that incorporates a strong loss prevention program may walk away from such engagements if the professional fees are not commensurate with the risk.

The officers of Selden Fox, Ltd. appreciate the opportunity to respond to this proposal. We are available to answer any questions the Agencies or Council might have. Please contact Sharon J. Gregor, Vice President of Accounting and Assurance Services at 630-954-1400.

Very truly yours,

SELDEN FOX, LTD

Sharon J. Gregor

Sharon J. Gregor
Vice President