

## Chapter 309

---

# SUPERVISORY COMMITTEE/AUDIT FUNCTION

### **Introduction**      Duties and Responsibilities

The Supervisory Committee (committee) is responsible for the annual audit, the verification of members' accounts, the internal audit function, and overseeing board of directors (board) or other issues which may impact the corporate credit union (corporate). Included in such issues is the monitoring of follow-up on open audit and examination findings until they are resolved.

Part 704 of the NCUA Rules and Regulations notes to the extent they are not inconsistent with Part 704, other regulations applicable to federally chartered or insured credit unions apply to corporates as well. Part 715 imposes a duty on committees to determine policies and control procedures are sufficient to safeguard against error, conflict of interest, self-dealing, and fraud. This means committee members must possess sufficient expertise in corporate operations to independently evaluate the adequacy of internal and external audit work in relation to the sophistication of the corporate's current and planned activities. The committee members should also possess the ability to determine if augmentation of industry standard internal and external audit scopes needs to take place, and whether supplemental audits should be performed in specific areas. Additionally, committee members must be bondable.

Part 704 Guidance Letter No. 2, issued August 12, 1997, imposes additional duties on corporate committees with expanded authority. Such committees must consider the need for and timing of an external risk management review function which will test the reliability of models and systems employed by management to determine the level of risk the corporate is taking. Factors to be considered include the current known level of risk being taken, the status of the corporate's models and systems relative to their state of the art, the levels of knowledge and technical expertise exhibited by staff, and recommendations of auditors and examiners.

Due to the complexity of corporate operations, it is not unusual for the committee to work closely with management in developing corporate's internal audit program and determining the necessity of third party risk management reviews. However, the committee must clearly demonstrate independence in decision-making in these areas, and in all

other areas of committee responsibility. Documentation in support of such independence should be present in committee meeting minutes, written committee procedures for the auditor evaluation and selection processes, internal audit scope determinations, and other areas of committee responsibility where written standards and guidance are appropriate. If no such documentation exists, the corporate examiner (examiner) should recommend that it be developed and maintained. If there are any questions as to the committee's independence, this should be discussed with the Corporate Field Supervisor (CFS).

### CPA Opinion Audit Required

Section 704.15 of the NCUA's Rules and Regulations requires corporates to obtain annual opinion audits from an independent, duly licensed certified public accountant (CPA). This audit must be performed in accordance with generally accepted auditing standards and the audited financial statements must be prepared consistent with generally accepted accounting principles (GAAP), except where law or regulation provides for departure from GAAP (e.g. classification of shares). The committee shall submit the audit report to the board. A copy of the audit must also be submitted to the OCCU Director within 30 calendar days after its receipt by the board. A summary of the audit report shall be submitted to the membership at the next annual meeting. The summary audit report is often incorporated in the corporate's annual report.

Upon OCCU's receipt, the annual audit report is generally sent to the district examiner for review. If the examiner in charge (EIC) is not the district examiner, he or she should review the audit report and management letter for items relevant to the examination. If a management letter is not issued, the corporate should obtain a letter from the CPA firm confirming conditions did not warrant issuance of a management letter.

Other industry standard audit-related correspondence should also be reviewed. Such correspondence includes the audit engagement letter, representation letters issued by corporate management and corporate counsel, as well as the CPA firm's independence letter. If these letters are missing, or if they contain language out of the ordinary, the reasons for this should be investigated.

Scheduling the Review of the Audit Work Papers

Part of the pre-examination process includes sending a pre-examination letter to the corporate. Scheduling review of the audit work papers is coordinated through this letter. Typically, the EIC will review the audit and verification work papers during the pre-examination week. Communicating the results of the audit work paper review to the committee chairperson is recommended.

Section 704.15(b) requires that, if requested, audit work papers are to be made available for NCUA's review. Despite this regulatory requirement, some auditing firms have requested that examiners sign a release statement before the firm will provide the documents to NCUA. Examiners are not required to honor, nor should they honor, this request. If the auditor continues to deny access to the work papers, the examiner should notify the CFS. The notification should include the name and address of the auditing firm, as well as the name of the applicable partner. The CFS will provide the information to the OCCU Director, who will send a letter to the auditing firm citing the regulatory requirement that work papers are to be made available for review.

If the auditing firm continues to deny access to the work papers, the corporate's committee chairman should be notified of the problem. It is the ultimate responsibility of the committee to ensure the corporate is in compliance with the audit requirements of the regulation.

Sarbanes-Oxley Act of 2002 (H.R. 3763)

This legislation was enacted in response to several corporate governance scandals, including Enron Corporation and Global Crossing Limited. While this Act's requirements apply only to public companies, examiners should encourage committee members to familiarize themselves with the Act's requirements, encouraging them to voluntarily adopt those provisions which are consistent with sound business practices.

Examples of such actions might include:

1. Requiring an inquiry as to whether the CPA firm being considered for the audit engagement has registered with the Public Company Accounting Oversight Board, and whether it has ever been sanctioned by this body;
2. Requiring audit partner rotation; and

3. Establishment of a confidential employee “whistleblower” and member complaint handling process.

NCUA Letter 03-FCU-07 provides a summary of those sections of the Act which may have relevance to corporate credit unions. Committee members are expected to be familiar with the contents of this letter.

### Review of Annual Audit

The review of the annual audit is an important step in the examination process. The quality of the work and cited conclusions can be a factor in determining the scope of the examination. A comprehensive audit, qualified only with respect to the classification of member shares as equity, can give the examiner added basis for confidence in the accuracy and reliability of the corporate's records. This confidence can limit the extent or scope of selected reviews. Conversely, an inadequate audit may cause the examiner to expand the examination's scope.

An audit is the critical and systematic examination of the financial statements, records of accounting transactions, and internal controls of the institution. An acceptable audit is one satisfying the requirements of each particular engagement when judged by professional standards of performance.

It is not possible to define exact standards of acceptability for all corporate credit union audits. The examiner must use professional judgment to determine whether the audit fulfills all required elements. At a minimum, the audit report must meet the requirements of Part 715 of the NCUA Rules and Regulations, to the extent these are not inconsistent with corporate credit union requirements set forth in Section 704.15.

If the audit disclosed areas that indicate material operational or financial weaknesses, the external auditor should do more than merely certify the numbers. If the examiner concludes that the audit does not adequately address all concerns, the situation will first be discussed with the CFS prior to discussion with the committee and the board. Moreover, the examination report will contain appropriate verbiage to reflect the nature of these discussions.

Guidance on auditing standards that must be met can be found in the AICPA's *Audits of Credit Unions*. However, there may be cases in which minimum standards are not adequate to evaluate the specific services or circumstances in a particular corporate. Based on the risk

exposure and other circumstances in each corporate, the examiner must judge if an audit fulfills the regulatory requirements.

An examiner should consider an audit unacceptable if:

1. Material parts of the audit were not performed;
2. Material parts of the audit cannot be supported by work papers;  
or
3. Material areas of the corporate's operations were not audited.

When an examiner takes exception to the annual audit, the following information should be provided to the corporate and documented in the examination work papers:

1. Specific audit sections in question;
2. Records or accounts with significant errors or record keeping deficiencies;
3. Material area(s) unreviewed; and
4. Time anticipated to resolve the problems.

If an examiner cannot determine if the CPA adequately completed certain audit steps, or questions the CPA's independence or competence, the concerns should be discussed with the CPA. During the meeting, the examiner should determine if and how the CPA used additional audit steps. At this time, however, the examiner should not make any statements as to the acceptability of the audit, if, in fact, it is deemed to be unacceptable.

Examiners must maintain their objectivity and independence. They should reserve adverse comments for the final meeting with the committee. The examiner should explain the audit deficiencies to the auditor and provide the auditor an opportunity to comment. If the auditor agrees, the parties involved should reach agreement concerning what and when corrections will be made. In all cases, examiners will discuss major audit findings with the committee and document them in their examination work papers.

If the examiner cannot come to an agreement with the CPA on the deficiencies, the CFS should be contacted. The examiner should not rate the audit as unacceptable. NCUA must afford the independent accountant "due process." For NCUA to prevail in a due process proceeding, OCCU staff must document that the CPA did not present financial statements consistent with GAAP, or that the CPA did not perform the audit scope, procedures, testing, and reporting consistent with GAAS.

When NCUA deems a CPA's work unacceptable, examiners have several options:

1. Recommend that the committee cause to be performed the additional necessary tests, within an appropriate timeframe before the next examination, to provide NCUA with needed assurance;
2. Recommend to the board and the committee they include additional special procedures in the engagement letter in future audits; or
3. Recommend the agency enforce appropriate FIRREA actions, as deemed necessary.

If the issue cannot be resolved with the corporate and the committee, the CFS should consult with the OCCU Director to determine how the concern should be advanced to the Office of Examination and Insurance (E&I) and the Office of General Counsel (OGC). If the examiner, CFS, and OCCU Director are in concurrence, the examiner should consider the CPA's work "pending further review" until judged to be either acceptable or unacceptable. Examiners will not require the corporate to have another CPA redo the work unless the OCCU Director directs such action.

To facilitate the submission to E&I and OGC, the examiner should provide the following:

1. A memorandum summarizing the deficiency or deficiencies, accompanied by documentation supporting the examiner's position. The memorandum should be clear, concise, and fully supported by documentation sufficient for the state licensing authority, the AICPA Ethics Division, or NCUA through an administrative proceeding process, to track the facts and successfully draw the same conclusion as the examiner;
2. A copy of the credit union's engagement letter, management representation letter, and any other relevant contracts or correspondence with the CPA firm;
3. A copy of the examination report;
4. A copy of the audit report;
5. A description of the examiner's review regarding the CPA's work, and the CPA's working papers in determining inadequacy;
6. Documentation regarding attempts to resolve the inadequacies with the CPA;

7. A listing of the examiner's findings and exceptions provided to the committee, and any notes, minutes, transcripts, or recordings of the meeting held with it to discuss same; and
8. Any additional information or documentation evidencing the examiner's position which would persuade a reasonable person in a due process proceeding.

The prepared package will be forwarded to E&I to review, assess the merit of the case, and possibly enhance NCUA's position by adding appropriate references or language from professional literature (GAAP and GAAS), if needed. In some cases, E&I has been successful in initiating renewed dialogue with the CPA, which brings about resolution of the issues. However, if E&I is unsuccessful, OCCU will forward the package to OGC which will consider the possible courses of action, which include:

1. Referral to the state licensing authority;
2. Referral to the AICPA Ethics Division;
3. Prohibition action (in rare cases), if OGC can prove the grounds set forth in Section 206(g) of the FCU Act in an administrative hearing;
4. Cease and desist order (in rare cases) against the CPA for violation of law or regulation, or for committing an unsafe or unsound practice;
5. A civil money penalty (in rare cases) against the CPA for violating law or regulation; and/or
6. Cease and desist or civil money penalty actions against the corporate or its officials for failure to obtain an "acceptable" audit.

OCCU and the central office staff must work together to advance the case through the legal system to seek the appropriate resolution. At all stages of this process, all parties must understand the importance of good communication and feedback. Examiners should feel comfortable pursuing such cases through the established channels, confident that, in documented cases with merit, OCCU and central office staff will endeavor to obtain an acceptable resolution.

#### Auditor's Review of Internal Controls

During the analysis of the auditor's work, the examiner will pay particular attention to the internal controls and operational procedures review. If the audit does not include a review of internal controls in major areas such as payment systems and/or investments, discussion

with the supervisory committee will emphasize the need to obtain an internal control audit covering these crucial areas. Deficiencies will be addressed in the executive summary, as appropriate.

### Status of Auditor's Exceptions/Recommendations

The Corporate Examination Procedures - Supervisory Committee Audit and Verification Review, OCCU 309.1P, and/or a suitable examiner designed work paper, will be used to list all exceptions/recommendations noted by the auditor in the audit report or management letter. A copy of these reports may be attached to OCCU 309.1P in place of the pertinent auditor comments. Steps taken by management to correct any of the noted exceptions and/or to implement auditor recommendations, as well as the current status of the corrections/recommendations, must also be documented.

### Internal Audit

A corporate with average daily assets in excess of \$400 million for the preceding calendar year, or as ordered by the OCCU Director, must employ or contract, on a full- or part-time basis, the services of an internal auditor (Section 704.15b). The internal auditor's responsibilities will, at a minimum, comply with the Standards and Professional Practices of Internal Auditing, as established by the Institute of Internal Auditors. The internal auditor will report directly to the chair of the committee, who may delegate administrative supervision of the internal auditor's daily activities to the corporate's CEO. The internal auditor's reports, findings, and recommendations will be in writing and will be presented to the committee not less than quarterly.

Although not required by Section 704.15, corporates with assets less than \$400 million typically have internal audit functions. This is due to the risks posed by selected corporate operations (e.g., wires), regardless of asset size.

The committee and/or internal audit staff must develop an internal audit program which sets the frequency and scope of each internal audit. Examiners can provide input/guidance to the committee and the internal audit staff. However, such suggestions are usually limited to situations when there are deficiencies in internal audit scope (e.g., areas presenting material risk not being audited), internal audit

procedures (e.g., lack of follow-up procedures), or the frequency of internal audits is inadequate. Internal audit scopes should be geared toward a targeted risk approach.

Part 704 of NCUA's Rules and Regulations makes peer review mandatory. The rule specifies the responsibilities of the internal auditor, whether an employee or a contractor, must comply with the Standards of the Institute of Internal Auditors. The Standards call for at least one mandatory external quality control review every five (5) years.

**Examination Objectives**

The objectives of the supervisory committee and audit function review are to:

1. Determine that all regulatory audit requirements are being met;
2. Evaluate the effectiveness of the committee through review of its audit implementation and oversight processes;
3. Evaluate the independence and competence of those who provide the internal and external audit functions, as well as the overall adequacy of the internal audit function;
4. Determine the procedures performed by the internal and external auditors are adequate to identify and to prompt the correction of deficiencies representing material risk;
5. Evaluate the adequacy of the annual opinion audit and verification of members' accounts, relative to the corporate's needs;
6. Determine that areas of concern noted during the external and/or internal audits are followed up by the committee or internal audit staff for corrective action; and
7. Initiate corrective action (issuance of DORs and/or OEFs) when deficiencies are identified with either the committee, the annual audit process, or the internal audit staff/processes.

**Examination Procedures**

See Corporate Examination Procedures - Supervisory Committee (OCCU 309P).

See Corporate Examination Procedures - Supervisory Committee Audit and Verification Review (OCCU 309.1P).

**Examination Questionnaire** See Corporate Examination Questionnaire - Supervisory Committee (OCCU 309Q).

- References**
1. Federal Credit Union Act, Section 115, Supervisory Committee; powers and duties; suspension of members; passbook (12 CFR Section 1761d);
  2. NCUA Rules and Regulations, Sections 704.15 (Audit Requirements) and 715 (Supervisory Committee Audits and Verifications);
  3. AICPA Audit and Accounting guide, Audits of Credit Unions;
  4. NCUA's Examiner's Guide, Chapter 5, Supervisory Committee; and
  5. NCUA Letter No. 03-FCU-07, the Sarbanes-Oxley Act.