Comments on Part 715 ANPR, Supervisory Committee Audits

General

Following are comments on the Advanced Notice of Proposed Rulemaking (ANPR), labeled by question number contained in the ANPR.

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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.

While on the surface any attestation might appear better than no attestation, it is necessary to weigh the costs and benefits associated with the attainment.

Clearly there is a significant cost not only in obtaining the attestation from an independent auditor (which has been shown to double existing audit fees), but also there are considerable, less-easily quantified internal costs associated with preparing for the attestation and ongoing maintenance. Further, the costs involved, both explicit and implicit, will be borne by credit union members for whom the benefit is not as obvious as for those who hold shares in a publicly traded company.

However, both the NCUA and the GAO have made it clear that the primary reason for adopting an attestation requirement is to improve the NCUA's oversight of credit unions (specifically the prevention and detection of errors or fraud in financial reporting) by creating parity with regard to other insured institutions' financial reporting requirements. Fortunately, it hasn't been demonstrated that the NCUA's oversight of credit unions' financial reporting needs improvement. Clearly, the credit union charter is inherently less risky than state and federal bank and savings and loan charters. Relating to the reduced risks/opportunities, the incentives for fraudulent reporting are significantly reduced in the credit union industry. It would seem the disparity in financial and control reporting requirements that exist between credit unions and other types of financial institutions is in fact justified.

The benefit of a formally-tested attestation is dubious given the subjective nature of evaluating internal controls. Though there are widely-accepted models of internal control, the implementation and evaluation of them is by necessity a subjective process. It is unclear whether any significant measurable benefit would accrue to the NCUA as a result of the expenditures and efforts made by the insured institutions and their members.

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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.**

Certainly, the threshold shouldn't be lower than that used by the FDIC in an inherently riskier environment ($1B). The argument should be made that a higher threshold would highlight the inherently different risk environment for credit unions versus banks.

But, what is the correlation between asset size and the risk of errors or fraud in financial reporting? If a correlation exists, wouldn't the relationship be the inverse of what is suggested—smaller credit unions are at greater risk because internal controls are more likely to be resource-restricted?

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.**

Given the insured nature of both types of institutions, there appears to be no rationale for implementing different thresholds.

4. **Should management's assessments of the effectiveness of internal controls and the attestation by 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?**

Since credit unions don't have financial statement users in the sense of an active investment community, any covered reporting should be limited to reporting for regulatory purposes only (e.g. call reports).

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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.**

Integrating internal control reviews with financial audits would allow for efficiencies that may be difficult to obtain in separate audits, and thus should be permitted. However, freedom to use the marketplace to find the best practices and best prices should not preclude using separate parties for the two tasks.

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

Less frequent attestations are sufficient given the reduced risk of the credit union environment and the attendant costs. Any benefit of the attestation to the credit unions will result from going through the exercise the first time and perhaps at long-range strategic intervals; subsequent, interim exercises will be less-valuable while remaining costly.

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)?**

2008 – At least 30 months should be allowed to prepare for the attestation. Risk assessments, control identification, implementation of remedial actions, documentation, and testing will all be resource-intensive, will strain budgets, and will compete for resources allotted for more strategic projects.

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8. **If credit unions were required to obtain an "attestation on internal controls," should part 715 require that those attestations, whether for a natural person or corporate credit union, 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? Please explain your preference.**

The AICPA's revised AT 501 standard is preferable to the PCAOB's AS 2 standard, since the AICPA's standard would allow the financial audit and the internal control attestation to be performed at different times and by different entities.

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?**

This is an example of where the subjectivity of such attestations becomes woefully apparent. Although no specific model of internal control should be mandated, the attributes of acceptable models should be outlined. For example, does a control model have to be formally and widely recognized as such, and if so, how?

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?**

Most Supervisory Committees rely on outside expertise in obtaining the annual audit, and in practice use this same expertise to perform the member verification required by the Federal Credit Union Act. Since there are no other mandated duties of the Supervisory Committee and Committee positions are filled by volunteers, no special expertise should be required of Committee members of any size credit union.

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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?**

(Unclear what this means or would entail.)

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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?**

The proposal to prohibit Supervisory Committee members from being associated with large customers of the credit union should be rejected. The closed nature of many credit union fields of membership may make this requirement too burdensome.

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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.**

It would be difficult to find volunteers possessing the requirements proposed above. The proposed requirements make more sense in the for-profit environment where audit committee members are compensated and may be chosen from a large pool of qualified individuals. Since credit union volunteers come from the membership of the credit union, it may well be difficult to find financial expertise and/or independence from large customers of the credit union in individuals who are also willing to serve in a volunteer capacity. The inherent demographic limitation on a credit union with a closed-field of membership would exacerbate the problem.

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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? If not both, why not?**

Requiring auditor independence to satisfy both regulatory bodies is liable to narrow the pool of potential auditors for any given credit union. Given the supply problems this situation could create, (and the higher audit fees that would surely follow), independence by both standards should not be required. The AICPA's standard of independence is adequate.

15. **Is there value in retaining the "balance sheet audit" in existing §715.7(a) as an audit option for credit unions with less than $500 million in assets?**

Without being familiar with the extent to which the "balance sheet audit" is utilized by Supervisory Committees, more options are intuitively better than fewer since they allow Supervisory Committees to tailor their compliance with the regulation to the specific needs of their respective credit unions.

16. **Is there value in retaining the "Supervisory Committee Guide audit" in existing §715.7(c) as an audit option for credit unions with less than $500 million in assets?**

(Same answer as # 15. above.)

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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 to NCUA? If so, how soon after the audit period-end? If not, why not?**

If there is an effective process in place at the NCUA to review and make use of the reports sent to them in a timely manner, it is not problematic to forward a copy of the auditor's report. If the reports are unlikely to be scrutinized prior to an institution's examination, it makes more sense to simply continue providing them to the NCUA examiners when they arrive in the field.

Should Supervisory Committees be required to transmit a copy of the auditor's report to the NCUA, a period of three months after the date of the audit would allow the Supervisory Committee a reasonable amount of time to review the report with the auditor prior to remitting the report.

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?**

(Same answer as # 17. above.)

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?**

Yes, the Supervisory Committee should have the opportunity to review the reports with the auditors before the reports are transmitted to the NCUA.

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Comments on Part 715 ANPR, Supervisory Committee Audits, Continued

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?**

A target reporting date of 180 days after the audit period-end may considerably lower audit fees for credit unions operating on a calendar-year basis and would be enthusiastically supported.

Repeated negligence in including the target reporting date in the engagement letter may be reflected in the examiner's appraisal of "Management" during a regularly-scheduled examination.

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?**

Notification of the NCUA every time a credit union engages an auditor is unlikely to be helpful in the supervisory process.

Dismissal or resignation of an independent auditor outside of the original term of the engagement may be of greater interest to the regulator, and thus would warrant notification with the reasons for the dismissal or resignation.

22. **NCUA recently joined in the final Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters, 71 FR 6847 (Feb. 9, 2006). 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?**

The limited liability provision in some external audit engagement letters is cost effective for credit unions and is not commonly known to be a problem. Regulatory prohibition does not seem justified at this time. The same principle may be applied to the question concerning Supervisory Committees' right to waive the auditor's punitive damages liability.