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MAY02'06 AM 11:12 BOARD

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ISSUES TO CONSIDER

ATTESTATION AND INTERNAL CONTROLS AUDIT

- A. Does your credit union believe that there would be a significant impact on credit union operations, if NCUA were to require "attestation on internal controls"? Please explain.

YES. The attestation process first requires management to assess and report on the effectiveness of the credit union's internal control structure and procedures. This management assessment process, at a minimum, requires numerous steps: project planning, identification of key processes and controls, scope definition - areas of concentration/types of information/extent of the assessment process, flowcharts or narratives of key financial processes and the controls, documentation process, plus the evaluation of control deficiencies and the remediation of any deficiencies. Not to be underestimated is the corporate-wide education and training process required to comply with this proposed regulation. All managers and many of their employees will be actively engaged in this process, learning the requirements, identifying the controls, documenting and/or flowcharting the processes, and enhancing the control structure where necessary. Secondly, the attestation process requires the supervisory committee or the internal audit staff to work with the external auditors to determine the scope (including selection of internal controls to test so that credit union documentation will validate that the tested controls are operating as needed), testing plan development, and selection of testing methodology (testing strategy - extent and types of tests), and documentation strategy (sampling or observation).

It is critical that the project scope be defined by the regulator before work effort is started. This scope should be clear and concise, and limited to the essential data and information necessary for regulatory assurance of sound operations. Obviously, scope dictates the effort. A tightly defined scope with a LIMITED review of KEY CONTROLS over FINANCIAL STATEMENTS would be appropriate for credit unions rather than an assessment and attestation process of ALL CONTROLS over financial statements or all controls within the credit union.

If this type of requirement is mandated for credit unions, a two year or longer lead time for compliance should be granted. The learning curve concerning the requirements, the development of an implementation plan, and the plan itself will be a major effort for credit union staff. And, as with any regulatory change, this

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process must be implemented in addition to annual objectives and operational strategies included in the credit union's annual business plan. Also, while some external auditors already have experience with providing attestation services for publically-held companies, many will not have that experience, thereby increasing the overall cost of implementation.

B. Does your credit union believe that there would be a financial impact on the credit union, if NCUA were to require "attestation on internal controls"?

YES. The credit union financial cost is direct and indirect - direct expense for hours of external auditor expertise and indirect expense for credit union human and technical resources (employees from specialized areas such as accounting, internal auditing, and information services plus a significant percentage of managers).

Charles River Associates (CRA) and ARC Morgan conducted surveys in 2005 to evaluate the cost of implementing Sarbanes-Oxley 404 (SOX). CRA was commissioned by Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, and Price Waterhouse Coopers LLP. The surveys broke the data into two sections: Large companies (with market capitalization over \$700M) and small companies (with market capitalization of \$75M to \$700M). While not directly transferable to the credit union industry, the results speak for themselves as to the magnitude of the expense that could result from the SOX 404-like proposal.

For large companies, the first year cost was \$7.3M and the second year cost declined 42% to \$4.3M. Small companies reported a first year cost of \$1.5M and a second year cost of \$900,000 (a decline of 39%).

Both the large and small companies listed the same top two cost drivers.¹ Number one was the change in documentation efforts (53.4%). Number two was the effort to increase efficiencies in testing internal controls (17.8%). Overall 30% of both size companies stated their Internal Audit budget increased more than 75%. Both size companies were also asked to what extent of the 2005 budget (year two) is directly related to assessing and/or testing controls to meet SOX 404. Twenty-six percent of the companies replied that greater than 50% of the internal audit budget was directly related to meeting SOX requirements.²

First Year Cost:

Large companies (over \$700M in market capitalization)

\$7.3M (The \$7.3M figure can be broken down as follows:

¹Sarbanes-Oxley Section 404 Cost and Implementation Issues: Survey Update, by CRA International, December 8, 2005

²The Role on Internal Audit in Sensitive Communications, by Steven E. Kaplan and Joseph H. Schultz, Jr., January 2006 (IIA Institute of Internal Auditors)

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\$1.9M on audit-related fees
\$5.4M on implementation cost)
Small companies (\$75M to \$700M in market capitalization)
\$1.5M (The \$1.5M figure can be broken down as follows:
\$520K on audit-related fees
\$980K on implementation cost)

Second Year Cost:

Large companies (over \$700M in market capitalization)
\$4.3M (a decline of 42% from first year)
Small companies (\$75M to \$700M in market capitalization)
\$900,000 (a decline of 39% from the first year)

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? Please explain why or why not.**

NO. The “attestation on internal controls” should not be required of any credit union due to the immense expense. And, if it is required, a very narrow, highly defined scope needs to be determined before the regulation is implemented so that the maximum benefit can be achieved without consuming human resources and substantially increasing the audit budget. While there could be some benefit for some credit unions (e.g. the strengthening of some of their controls), the benefits would be overshadowed by the expense. (See expense estimates in Question B above). However, if the attestation process is valid for one credit union, it is valid for all credits unions regardless of asset size. In fact, small credit unions may have more need to document key financial controls than large credit unions due to the difficulty many times of having sufficient staff to segregate duties.

The “attestation” concept was evaluated by the NCUA in 1997/1998 and not implemented. While the awareness of this issue has been heightened due to SOX 404 requirements and GAO recommendations in two reports on credit unions, there is still no substantial benefit to be gained - in light of the estimated expense. At a time of proposed reductions in regulatory burdens for credit unions, this proposal would add a substantial costly burden. And, there would also be substantial costs for the regulatory agency, primarily in human resource expenses such as staff training and credit union monitoring.

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? Please explain.**

The attestation of internal controls should not be required for credit unions. However, if a minimum threshold was required, the level should be no less than \$10 billion in assets, a level that could be applied to credit unions and corporate credit unions alike.

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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? Please explain.

YES. No attestation on internal controls should be required. However, if a minimum is established, it should be the same for all regardless of the institution’s asset size, i.e. greater than \$10 Billion in assets.

- 4 (a). 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)? Please explain.

NO. ALL financial reporting should not be assessed for effectiveness; a limited review of KEY controls impacting the financial statements prepared in accordance with GAAP would be appropriate. Even a limited scope of KEY controls will be burdensome and costly. The scope needs to be restricted to a limited number of critical controls rather than all financial reporting controls.

- 4 (b). Should management’s assessments be more narrowly framed to cover only certain types of financial reporting? If yes, please indicate which types.

YES. A narrow scope of only KEY controls over an equally limited number of KEY processes would be most appropriate.

- 5 (a). Should the same auditor be permitted to perform both the financial statement audit and the “attestation on internal controls” over financial reporting? Please explain.

YES. The same auditor would be familiar with credit union operations, and, therefore the overall external auditor expense would be minimized as there would not be a learning curve concerning operations. There should not be a concern about independence and objectivity of professionals practicing auditing. However, if this is of concern to the regulator, SOX has outlined specific requirements for the objectivity and independence of external auditors.

- 5 (b). 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”? Please explain.

YES. This decision should be the credit union’s choice - similar to a credit union’s choice of federal or private share insurance coverage or a federal or state charter decision. However, it may not be cost effective to engage two different auditing firms.

6. If an “attestation on internal controls” were required of credit unions, should it be

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required annually or less frequently? Please explain.

It should be required no more frequently than biennially, preferably longer (3-5 years). Once the key processes are identified and documented by management, there will be a better understanding and awareness of the key controls and less likelihood that key controls will be eliminated or circumvented. And, if changes to the key controls are reported to the regulator at the time of their regularly scheduled review process, the regulator can test the controls at that time. This would be a more cost effective solution than an external auditor attestation requirement.

7. If an "attestation on internal controls" were required of credit unions, should the requirement become effective in the fiscal period beginning after December 15 of the year that the regulation is made final? If not, please indicate an effective date.

NO. The regulation should be implemented two years after the regulation is issued. A minimum two year advance notice of the implementation date should be used to assist credit unions with meeting the challenging and costly impact of the proposed regulation. For example, if the regulation is final December 1, 2006, the effective date should be no sooner than January 1, 2009.

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? If not, please indicate if the AICPA's revised AT 501 standard that applies to non-public companies should be imposed. Please explain.

This answer is a qualified yes as neither of these standards have been reviewed in depth. It appears that the PCAOB AS 2 standard is very specific in terms of guidance with 161 pages issued versus the 27 pages for the AICPA's revised AT501 standard. Generally, more specific guidance is better than guidance that may be subject to interpretation. If the AICPA guidance is revised for non-public companies and provides more specific guidance, similar to the PCAOB standard, the revised AT501 standard should be used. The standard to be followed should be specific in direction but not onerous in execution.

- 9 (a). 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? Please explain.

YES. The COSO model is an international model that is straight-forward and time-tested with a wealth of trained resources (external auditors) and published materials available. Many of these trained resources have been through the proposed process with experience gained by assisting publically-traded firms to comply with SOX 404 and banks/thrifts to comply with FDICIA (a lighter version of SOX and this

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proposed requirement for credit unions). The COSO model is supported by ongoing enhancements from the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and by it being the model of choice used by the international organization, The Institute of Internal Auditors (IIA). COSO is a voluntary, private sector organization sponsored by the American Accounting Association, the American Institute of Certified Public Accountants, Financial Executives International, The Institute of Internal Auditors, and the National Association of Accountants (now the Institute of Management Accountants). COSO has received input of representatives from industry, public accounting, investments firms, and the New York Stock Exchange. It's mission is to improve the quality of financial reporting through business ethics, effective internal controls, and corporate governance. It is a well-established, accepted standard world-wide.

Use of a standard model is highly recommended for consistency in use for regulatory review, credit union benchmark comparisons, and communication between entities who must now comply or have complied with SOX 404. There also is an abundant quantity of educational resource materials and seminars available, and experienced internal/external auditors. It would also be a very cost-effective tool.

- 9 (b). Should each credit union have the option to choose its own standard? Please indicate what that standard should be.

NO. The standard model should be COSO. [See answer to 9 (a) above.] There are many free or inexpensive COSO resources available. It can be effectively used by credit unions of all sizes. One common standard will also benefit regulators in their review and monitoring processes.

SUPERVISORY COMMITTEE COMPOSITION

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, please indicate what criteria they should be required to meet and what the minimum asset size threshold should be.

No asset size threshold should be set. Each Supervisory Committee should have a minimum of one financial expert (as defined by SOX), no matter the size of the credit union. It is a safety/soundness and best business practice issue.

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, please indicated at what minimum asset size threshold the requirement should apply.

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Again, this is a sound business practice and effective corporate governance that the Supervisory Committee (regardless of credit union size) have access to counsel, and, if they have access to outside counsel, they should also have the necessary spending authority to initiate the expense to benefit the credit union's members. In the event that outside counsel is sought, as a courtesy, the credit union's Chair should be notified. However, in the event of potential conflict with or unethical action by a Board or Board member, the Supervisory Committee should notify the regulator.

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, please indicate at what minimum asset size threshold the prohibition should apply.

NO. There should not be a prohibition that a Supervisory Committee member must not be associated with any large customer of the credit union. However, the Committee members should be required to sign a Code of Conduct or Ethics that states they will fully disclose any relationship (employee or other) that would be in conflict with any proposed action to benefit the credit union, and they must ask that their relationship be fully disclosed in the credit union Supervisory Committee and/or Board minutes. Also, the individual should abstain from voting on any issue where they have a personal connection. As a Supervisory Committee is composed of a minimum of three individuals, it is highly recommended that none of the individuals serving at the same time be associated with any one particular business. Supervisory Committee members are volunteers and receive no direct financial gain.

Also, an equally strong reason that any individual should be able to serve as a Supervisory Committee member is that a highly qualified financial expert with credit union ties (a member) is more likely to serve as a Supervisory Committee member than a nonmember and should not be excluded from consideration. There is not a large pool of individuals available who would be considered a financial expert under SOX guidelines and many of those individuals are already serving on audit committees of other organizations. And, as many charitable organizations are also now seeking these qualified individuals, the pool continues to shrink.

13. If any of the qualifications addressed in questions 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.

YES. See the answer to Question 12 above. The responsibilities of an audit committee member are critical. However, another issue for some volunteers is the potential of personal liability or reputation risk from serving in this role.

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INDEPENDENCE OF AUDITORS

14. Should a State-licensed, compensated auditor who performs a financial statement audit and/or “internal control attestation” be required to meet the AICPA’s “independence” standards and the SEC’s “independence” requirements and interpretations? If not, please explain why and which an auditor should meet.

YES. The SEC Independence Standard is generally understood to refer to a mental state of objectivity and lack of bias. The AICPA’s independence standard is one of maintaining objectivity and integrity in the performance of a professional service. Perhaps the AICPA’s Code of Professional Conduct which encompasses the standards of independence, integrity, and objectivity would be more appropriate rather than solely meeting the “independence” standard. If a state licensed, compensated auditor is not a certified public accountant following the AICPA standards, the SEC standard would certainly be appropriate as a requirement.

AUDIT OPTIONS

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

YES. It is a current standard that is in effect and applicable for smaller institutions, and certainly would be substantially more cost effective than the proposed requirements.

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? Please explain.

No opinion - no research completed to answer question.

AUDIT REPORTS

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, please indicate how soon after the audit period-end. If not, please explain why not.

NO. The financial statements are already sent monthly to the NCUA examiner plus the NCUA headquarters receives quarterly Call Reports. While the attestation of internal controls is a process that might strengthen internal controls at some individual credit unions, it should not be necessary to submit the auditors report. If the NCUA needs to know that there is a material internal control deficiency at a credit union, a disclosure of the type of deficiency could be submitted on the quarterly Call Report, and only if there is a material deficiency should the credit union be required to file the full report.

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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, please indicate how soon after the credit union receives it. If not, please explain why not.

NO. See above answer to Question 17. The NCUA collects this type of information routinely as part of their ongoing monitoring process. It is unnecessary to be regulated. If a deadline is necessary, the quarter following the completion of the external auditor's issuance of the annual report should be specified.

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, by today's definition, has direct oversight responsibilities for the credit union's financial reporting, compliance, and risk management activities.

AUDIT ENGAGEMENT LETTERS

- 20 (a). 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. Is this period adequate? Please explain if it is. Or, if not, explain if it should be longer or shorter.

YES. The period is adequate. The time period allows adequate time for external and internal auditor work, Supervisory Committee review, printing of the Annual Report, the Annual Meeting of the Membership, and the mailing of the Annual Report to the regulator. If the time period is changed, an additional month would allow more time to ensure the receipt of the Annual Report by the regulator.

- 20 (b). Should sanctions be imposed against a credit union that fails to include the target delivery date within its engagement letter? Please explain.

NO, a verbal warning for a first time offense is adequate. However, if the credit union continues to not comply, a small monetary sanction should be assessed for the second offense, and a major sanction be imposed for three or more offenses.

- 21 (a). 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? Please explain.

NO. The credit union enters into an engagement with an auditor for a business reason. An auditor's dismissal or resignation should remain an operational issue, not a regulatory issue unless there is an auditor that is unethical, incompetent, or performing services in a manner that violates laws or regulations.

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21 (b). If so, in cases of dismissal or resignation, should the credit union be required to include reasons for the dismissal or resignation? Please explain.

NO. This information is not needed unless the termination was the result of unethical, unscrupulous, or criminal behavior. In that case, the name of the firm should be reported to protect other credit unions.

22 (a). 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? Please explain.

YES, any third party performing work on behalf of the credit union should be held accountable and liable. However, auditor liability is frequently limited by the organizational structure of the firm, e.g. the LLP structure.

22 (b). Should Supervisory Committees be prohibited from waiving the auditor's punitive damages liability? Please explain.

YES. Safety/soundness and risk issues are the responsibility of the Supervisory Committee, working on behalf of the Board and the membership.