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Gerald Poliquin, Secretary of the Board
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Comments of Proposed Rule Supervisory Committee Audits and Verifications

Our firm has been providing supervisory audit services to credit unions for thirty years.

We fully agree that the Supervisory Committee Guide for Federal Credit Unions Revised December 1999 has several outdated sections including some of the minimum procedures in Appendix A. We have reviewed the proposed changes to 12 CFR part 715. The following observations and suggestions are offered:

Elimination of the 120 day target date

We fully agree with the elimination of the 120 day target date. The external auditor and supervisory committee will be able to agree to a timely expected date for issuance of the report.

Proposed Appendix A

We believe that there are numerous unintended consequences that will surface if Appendix A is adopted as proposed. The first unintended consequence will be that the supervisory committee audit time will at least double resulting in much higher fees to be paid by the credit union due to the number of member share and loan accounts requiring testing and confirmation procedures. NCUA has stated that the "proposed rule will provide relief to small credit unions by clarifying and simplifying requirements related to supervisory committee audits." In our opinion, the confirmation requirements for loans and shares will result in a significant increase in audit time with minimal benefit. This will result in a significant negative economic impact on small credit unions. Our suggestions will result in there not being a significant economic impact.

Observation 1 – As part of our current supervisory audit services that we provide to every credit union, **all balance sheet accounts are traced to supporting schedules, reconciliations or subsequent clearing.** We believe that this procedure should be added as the first item to Appendix A. By performing this procedure, we can determine which balance sheet accounts are out of balance, not reconciled or do not timely clear. By performing this procedure, several tests and confirmations of material asset, liability and equity accounts would not be required.

Observation 2 – **The proposed procedure to test and confirm material asset and liability accounts should be changed to test loans, confirm or perform alternate procedures if confirmations of cash on deposit, investments and borrowings are not returned.**

It is more than a duplication of efforts to require the confirmation of loans and shares when a bi-annual verification of accounts is performed. Days of time and effort would be incurred to perform a positive or negative sample and thus double or triple the cost of a supervisory audit.

Loans- In my discussions with credit union clients, they prefer that a positive verification of share and loan accounts not be performed. Management does not want their members contacted by an auditing firm because they believe that the member will be calling the credit union to find out what problem the credit union is experiencing, thus increasing reputation risk and invalidating the confirmation.

Also, in this age of identity theft, members will not return positive confirmations to a third party that they have no relationship.

From an auditor's point of view, even in opinion audits, accounting firms do not perform positive confirmations because the return rate is so low. Some firms rely on the supervisory committee's bi-annual negative verification of accounts and perform alternate procedures such as reviewing a sample of new loans generated for compliance to loan policy, proper underwriting standards and comparing a computed amortized loan balance to the loan balance in the core processing system.

By comparing the computed amortized loan balance based upon the note payment terms to the core processing system, at a minimum the last three loan payments will be reviewed as well as the noting the date of the last loan payment and loan balance. Thus, the existence of the loan is verified as well as the payment history being reviewed and verifying that the core processing system is properly amortizing the loan. These procedures are adequate for audit purposes and confirmations are not required.

If NCUA believes that these alternative procedures are not adequate and still requires confirmation, the bi-annual negative verification can be performed by the supervisory committee, the outside compensated person or the outside compensated person can oversee the negative verification process being performed by the credit union's statement processor. In our opinion, this would satisfy the confirmation of loans and shares.

Confirmation or alternate procedures for cash on deposit, investments and borrowings – Technology and reporting advances need to be considered in the validation of account existence and replace the confirmation process. The auditing firm can be added as an interested party and receive the monthly statements from the brokerage firms. Thus, a statement is received directly from the brokerage firm and this is a form of direct third-party verification without a specific confirmation being generated.

Many brokerage firms have statements available on-line for credit unions. Multi-factor authentication is required to access the statements. If two employees with access rights sign in when the auditor is present and print out the statements, the same result is obtained as the broker responding to a confirmation and sending the statement by mail.

Many brokerage firms as well as banks are utilizing third parties for audit requests. When a confirmation request is received by a brokerage or financial institution utilizing a third party, the original confirmation is returned to the auditor stating that all audit requests are to be fulfilled through the third party and a fee for providing the confirmation will be charged. In these cases since the confirmation request is not being fulfilled by the financial institution, obtaining the audit period end and subsequent month statements on-line or at the credit union and comparing ending and beginning balances are alternate procedures that verify the existence of the accounts.

At a minimum, alternate procedures when confirmations are not returned needs to be acceptable.

Observation 3- The definition of test needs to include account analysis as an acceptable procedure. As an example – For all credit unions that we provide supervisory audit services, we perform a payroll analysis where the expense in the income statement is compared to the total payroll expense reported on Form 941s. If there are material differences, they are reconciled. Thus, account analysis needs to be added to the test procedures.

Observation 4 – Test and confirm material asset and liability accounts – Applying the definition of 5% of net worth to the volume of transactions as material, ATM, ACH and debit card liability holding accounts would have to be tested and confirmed. They could be tested by tracing some transactions to the corporate transaction or ACH accounts but since most credit unions either clear or reconcile these accounts on a daily basis, tracing any end of day balance to a reconciliation would be more appropriate and would be performed if our suggestion in Observation 1 above is implemented. These holding account balances cannot be confirmed.

Observation 4 – Test material equity, income and expense accounts – Based upon the 5% of net worth definition, loan and investment interest income would always be tested. We prepare a computed rate of return based upon monthly loan and investment balances and compare the calculated amount to weighted average rates calculated by the core processor or investment reports. Variations of over 100 basis points are investigated. **Again, adding account analysis to the test procedures is required.**

Observation 5 – Reviewing key internal controls, at a minimum: **Other real estate owned and foreclosed and repossessed assets are not material amounts as a percentage of total assets. These two categories should be removed.**

Wire and ACH transfer controls - We believe that you are including incoming and outgoing wire controls and ACH origination and receipt. Clarification should be added.

If documentation of walk throughs for each of the internal controls were performed, then the review and testing of the controls would be sufficiently performed.

Observation 6 – A review of board minutes for the audit period is not required in the proposed Appendix A. In our opinion a review of board minutes would provide the auditor with a good overview of board decisions affecting operations. This should be added as a requirement.

Observation 7 - The Supervisory Committee Guide for Federal Credit Unions Appendix A listed out detail procedures to be performed in a supervisory audit. The proposed amendment does not. **We suggest that detailed procedures be written and included in the proposed Appendix A.**

The proposed amendments are skewed to confirming loans and shares that should not even be included in the amendment since a bi-annual verification is performed and can be relied upon.

A $34,000,000 credit union with 3,700 share accounts would require a 349 sample size at a confidence level of 95% and a margin of error of 5%. The same credit union having 1,250 loans would require a 295 sample size at a confidence level of 95% and a margin of error of 5%. We believe that it is not an intended consequence for 644 member share and loan confirmations to be prepared by applying the proposed amendments. A credit union of this asset size can have their supervisory audit performed in less than 4 days utilizing the current Appendix A. Preparing, supervising and mailing all these confirmations, performing alternate procedures when the confirmations are not returned as well as performing the other audit procedures could double to triple the time required to perform the supervisory audit.

Unless the proposed amendment allows the bi-annual negative verification of accounts to be acceptable for the confirmation of loans and shares, we believe that the proposed amendment should not be implemented. As currently written, we believe that it is not achieving – simplification and the credit union not incurring a significant negative economic impact. Further clarification is required.

Observation 8 – Are the real objectives of an other supervisory audit being met in the proposed Appendix A? All that the proposed Appendix A is doing is performing a stricter balance sheet audit on the majority of the balance sheet. The objective of the other than supervisory audit should be that procedures performed result in the acknowledgement that balance sheet account balances are fairly stated. This is accomplished by tracing balance sheet account balances to reconcilations, supporting schedules and subsequent clearing. We believe that an emphasis on proper balance sheet presentation is what an other supervisory audit should encompass.

Conclusion

Replace the testing and confirming material asset and liability, equity, income and expense accounts with the tracing of all balance sheet accounts to reconcilations, supporting schedules and subsequent clearing as discussed in Observation 1. Require that documentation of any accounts not properly balanced or supported be prepared.

Remove reviewing key internal controls for other real estate owned and foreclosed real estate.

Keep the testing of the allowance for loan losses calculation and testing of loan delinquency and charge offs in the required procedures.

Bank Secrecy Act Independent Testing, the ACH audit and SAFE Act testing will continue to be additional services that can be engaged and are not part of Regulation 715.

We would be pleased to discuss this correspondence with the technical staff that have prepared the amendments.

Very truly yours,

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