McGladrey & Pullen
Certified Public Accountants

McGladrey & Pullen, LLP
150 North Hill Dr., Ste. 27, Brisbane, CA 94005-1019
O 415.468.7470 F 415.468.7474
www.mcgladrey.com/cu

Date: April 18, 2006

To: The National Credit Union Administration

Introduction: The National Credit Union Administration has requested public comment on whether and how to modify its Supervisory Committee audit rules to require credit unions to obtain an "attestation on internal controls" in connection with their annual audits; to identify and impose assessment and attestation standards for such engagements; to impose minimum qualifications for Supervisory Committee members; and to identify and impose a standard for the independence required of State-licensed, compensated auditors. The following comments are in response to your request:

Comments

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.

No. There are two primary reasons that support the position that an attestation on internal controls should not be imposed on credit unions.

- First, Sarbanes-Oxley was designed for and imposed only on publicly-held companies. In the past, particularly the recent past, publicly-held companies have engaged in fraudulent activities including issuing materially inaccurate financial statements that massively misstated financial performance. These fraudulent financial reporting activities have brought down several global high-risk enterprises and caused losses to investors totaling billions of dollars. These publicly-held companies have unique characteristics such as size, complexity and most importantly they operate in an environment that creates tremendous financial reporting pressures. CEOs and CFOs of these publicly-held companies are under tremendous pressure to "make their numbers." Unfortunately, some CEOs and CFOs are constantly hunting for wiggle room in the accounting standards or other tactics to find help for their bottom line. The incentives for CEOs and CFOs to engage in this fraudulent behavior are great because the rewards for making or exceeding market expectations are huge – billions of dollars are in the balance. The credit union environment could not be more different; consequently, the incentives to misstate financial reports are virtually nonexistent in the credit union environment. Consider the following:

- In credit unions, the temptation to engage in fraudulent financial reporting is minute because the reward is minute. Credit unions are not publicly held, there is no market for their stock; consequently there is virtually no incentive to fudge the numbers. David Wood, a managing director in Standard & Poor's Ratings' corporate and government services group, described the practices that contributed to the corporate failures that gave rise to the Sarbanes-Oxley Act: "The combination of aggressive management practices creating rapid short-term revenue and stock price growth, coupled with weak board oversight, allowing the CEO to rapidly accumulate personal wealth through stock-based incentive compensation, has been present in a significant percentage of recent problem situations." These practices simply do not exist in the credit union environment.
- Congress recognized that additional safeguards were needed to address the publicly-held environment where the rewards and incentives to break the rules will always be great. Sarbanes-Oxley was crafted precisely for the illness in the publicly-held environment. But the credit union environment could not be further from the multi-conglomerate publicly-held environment. To take medicine prescribed for a disease you do not have is not a wise or cost-effective course of action.
- Before a burdensome new regulation is imposed on an industry, the business case needs to be made as to why the regulation is needed and that the benefit from the regulation outweighs the cost. The business case would need to include examples of on-going material losses incurred due to significant fraudulent misstatement of credit union financial reports. Our experience tells us that these examples, particularly of the magnitude that spurred the Sarbanes Oxley Act, simply do not exist in the credit union environment.

- Second, imposing on credit unions an attestation on internal controls over financial reporting will impair a credit union's ability to serve their members and adversely impact a credit union's ability to compete. Today, the financial press is replete with complaints from the publicly-held business community about the high cost of complying with the requirement for an attestation on internal control environment (Section 404 off the Sarbanes Oxley Act). Serious questions about the cost-benefit of the attestation on internal control required by Sarbanes-Oxley are being raised by corporate America, financial professionals, Wall Street experts and academia. Studies have shown that the cost of an attestation on internal controls is significant and more importantly that the cost is disproportionately burdensome on smaller enterprises. Credit unions, even the very largest ones, would be considered among the smaller enterprises relative to the publicly-held sector; therefore, we must assume that if the attestation on internal control is financially burdensome for the publicly-held sector then it will be even more burdensome for credit unions. A recent survey of 217 large public firms with average revenues of $5 billion concluded that the cost for year one compliance averaged $4.36 million. (Financial Executives International Survey: "Section 404 Costs Exceed Estimates," March 2005.) This survey indicated that costs for the attestation on internal control can be divided into three cost categories with each category roughly approximating the cost of the others. The categories of costs include:

  - Cost Category #1 - The auditor attestation fees (which can exceed the cost of the financial audit by 300% or more);

- Cost Category #2 - External consulting costs to assist management with the design and documentation of the internal control system and also assist management in gaining an understanding of the complex requirements of Sarbanes – Oxley Act section 404 and the Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2, An audit of Internal Control Over Financial Reporting;
- Cost Category #3 - Internal costs for personnel and resources utilized in designing, documenting, evaluating and testing internal controls.

While the total costs to any individual credit union would be less than the costs incurred by these large public companies, credit unions still can expect these costs would represent a significant financial expense for the credit union. Such costs for credit unions can be estimated by extrapolating from the credit union's current opinion audit fee. For example, if a credit union is currently paying audit fees of $40,000, the additional total cost of complying with the Sarbanes-Oxley attestation on internal control could be in the $300,000 to $400,000 range. A major determinant of this cost will depend on the particular operating characteristics of the credit union; accordingly, the actual cost could vary significantly from this estimate.

Other drawbacks to consider when evaluating the imposition of Section 404 of the Sarbanes-Oxley Act include:

- It is not difficult to anticipate an argument coming from the banking community that since credit unions need to be regulated the same as publicly-held companies, and since their risk-profile is such that the regulators are imposing Sarbanes Oxley Section 404, then credit unions should be taxed in the same manner as publicly-held companies.
- The imposition of Sarbanes-Oxley on credit unions could have political repercussions as it would blur the distinction between credit unions and other publicly-held companies, particularly publicly held banks. It is possible that this could cause some credit unions to lean towards conversion to non-credit union charters such as the mutual savings bank charter. Pro-mutual savings bank proponents could argue that since this "regulatory compliance tax" which is designed for publicly-held companies is also being imposed on credit unions, then credit unions are paying a "regulatory compliance tax" without receiving the benefit of access to the public capital markets which derive to publicly-held companies. Therefore, if this most expensive component of Sarbanes-Oxley is imposed on credit unions, some may argue that a conversion to the mutual savings bank charter should be considered. Please note that the above-described hypothesized position of mutual savings bank proponents or community banks do not represent the commenter's thinking; rather this comment is intended to caution about possible unintended and harmful consequences of a regulatory requirement to treat credit unions as publicly-held companies.

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.

In accordance with the response to question 1, no credit union of any asset size should be required to obtain an "attestation on internal controls." However, if a regulation is imposed, the asset size should be significantly higher than that imposed by other regulators of non-publicly-held financial institutions; for example, the $1 billion threshold imposed by the FDIC Improvement Act on banks.

It should be noted that regulators who imposed Sarbanes-Oxley have been showing signs of re-thinking the thresholds that were initially established based upon information that has been analyzed regarding the high costs of the "attestation on internal controls" component of Sarbanes-Oxley. There are many organizations including large and small publicly-held companies who maintain that the cost of this regulation well exceeds the perceived benefits of the regulation. In light of this information the FDIC has increased the threshold for financial institutions from $500 million to $1 billion, an indication that the FDIC understands the cost/benefit dynamic and has concluded that the cost is disproportionately burdensome for smaller companies. The NCUA should review and consider the SEC Advisory Committee's report on Smaller Public Companies that has been issued in draft form and is soon to be published as a final report. Many of the conclusions argue for scaling regulatory treatment for companies based on size and completely exempting the smaller companies from the "attestation on internal controls" component of the Sarbanes-Oxley Act.

Additionally, the NCUA should consider that a $1 billion bank poses considerably more risk due to the authority it has to invest in higher risk assets and obtain higher risk and complex borrowing instruments. These organizations, given the complexity and risk of their balance sheet, also have a higher degree of accounting and financial management complexity than credit unions. Credit Unions in general have substantially more risk-based capital than banks. Accordingly, if the NCUA uses the FDIC Improvement Act as a model for the threshold then the credit union threshold, given the lower risk and complexity, should be a significant multiple of the FDIC imposed threshold.

It should not be overlooked that at this time the regulators who have imposed Sarbanes-Oxley on publicly-held and non-publicly held companies are moving in a direction that reduces the number of companies who are required to obtain the "attestation on internal controls" component of Sarbanes-Oxley. The NCUA is to be commended for their wisdom and patience in not moving precipitously in imposing Sarbanes-Oxley as other regulators have, and I encourage the NCUA to continue in this manner. The following is a selection of quotes from the Final Report of the Advisory Committee On Smaller Public Companies To The U.S. Securities and Exchange Commission that demonstrate the concern over the cost/benefit issues surrounding Section 404 of the Sarbanes-Oxley Act.

- "After thorough consideration of the evidence presented, we believe that Section 404 represents a clear problem for smaller public companies and their investors, one for which relief is urgently needed."

- "During the early stages of implementation of Section 404, it became clear that smaller public companies, due to their size and structure, were experiencing significant challenges, both in implementing that provision's requirements and in applying the SEC and PCAOB-endorsed COSO Framework. Many expressed serious concerns about the ability to apply Section 404 to smaller public companies in a cost-effective manner, and also about the need for additional guidance for smaller businesses in applying the COSO Framework. Against this backdrop, and at the encouragement of the SEC staff, COSO in October 2005 issued for public comment an exposure draft entitled "Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting." While intended to provide much needed clarity, the guidance has to date received mixed reviews, with many questioning whether it will significantly change the disproportionate cost and other burdens or the cost/benefit equation associated with Section 404 compliance for smaller public companies."
- "Disproportionate Impact: The Smaller You Are, The Larger the Hit" – This is the title of the section that discusses Section 404 costs. The following sums up the findings. "The lack of proportionality of the cost and amount of resources devoted to Section 404 compliance for smaller public companies is evidenced by data which shows that the expected cost of Section 404 implementation, as a percentage of revenue, is dramatically higher for smaller public companies than it is for larger public companies." Credit unions should be cautioned that although they frequently think that a $1 billion credit union is a large company, in fact, a $1 billion credit union is a small company relative to the U.S. marketplace. Warnings about the dramatically high cost of Section 404 for smaller companies must be taken to heart by credit unions.

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.

No. An attestation on internal controls should not be imposed on corporate credit unions for the same reasons stated in the response to questions 1 and 2. There is not a significant distinction with regard to risk and complexity between natural person credit unions and corporate credit unions. In reality, corporate credit unions with their relatively small loan portfolios may actually have less default risk per asset dollar than natural credit unions. Therefore, should the NCUA choose to impose the "attestation on internal controls" component of Sarbanes-Oxley on corporate credit unions, the asset threshold for corporate credit unions should be higher than the threshold for natural person credit unions.

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?

For credit unions with total assets exceeding $10 million, regulatory reporting must comply with GAAP. Accordingly, the "attestation on internal controls" component of Sarbanes-Oxley would be accomplished for both regulatory reporting and GAAP reporting to third parties using the same standards. However, in those instances where regulatory reporting requires information and details that are more extensive than that required for GAAP financial reporting, there may be an increased cost for the "attestation on internal controls" that pertain to regulatory financial information that is more extensive than that required for GAAP financial reporting. An exemption from the "attestation on internal controls" for instances such as this should be considered.

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.

Currently, PCAOB Statement 2 requires that the auditor who performs the "attestation on internal controls" also perform the financial statement audit. Should the NCUA want to amend the standard for credit unions to allow a credit union to use different auditors, the NCUA should consider the pros and cons of proposing an approach that is not within the scope of current standards.

In concept, it is possible that if different auditors are allowed to perform these attest engagements, then the credit union would be able to select the most cost-effective approach. If different auditors are allowed to perform the two attest engagements, the financial statement attest auditor would need to impound into their fees the cost of the procedures the financial statement attest auditor would have to perform to assure themselves of the quality of the work of the internal control attest auditor. These "other auditor assurance procedures" would have to be factored into the fees charged to the credit union. In the event of audit failure, the litigation would be more complex and therefore more expensive; however, the credit union could potentially have two audit firms to look to for damages.

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

Requiring the "attestation on internal controls" less frequently than annually seems to have the appeal of costing less than an annual requirement. Studies indicate that while high compliance costs persist after year 1, there is an expected modest reduction in costs (7.4% based on a NASDAQ and American Electronics Association survey) for subsequent years. It is interesting to note that the cost reduction is higher for large companies and lower for small companies, indicating that credit unions could expect smaller cost reductions in succeeding years. If an attestation on internal controls is required, the NCUA could consider requiring it periodically, perhaps once every three to five years. This relaxation of the annual requirement of an "attestation on internal controls" could be coupled with an annual requirement that the CEO report to the Board of Directors and the Supervisory Committee on their assessment of the design and operating effectiveness of the internal control system. It can be argued that corporate governance principles and corporate due diligence standards have always required the CEO to make such a report, and that the Board of Directors and the Supervisory Committee with their internal control oversight responsibilities should have been asking for this all along. It begs the question why none of us asked that this be done until Sarbanes-Oxley appeared on the scene.

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)?

If such a requirement becomes a reality, given the disproportionate burden this has created for small companies there should be a generous amount of time for credit unions to prepare themselves for compliance. Assuming a regulation enacted in 2006, effective date for fiscal periods beginning after December 15, 2010 would be an adequate amount of time for a credit union to prepare for and comply with the new regulation. In order to reduce the burden on credit unions, the NCUA should provide additional guidance by outlining approaches and best practices for management to conduct a cost-effective self audit of internal controls.

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.

When PCAOB developed AS No. 2 it did not contemplate that this standard would be applied to non-public companies. Since neither natural person credit unions nor corporate credit unions are public companies, and for reasons explained in the responses to questions 1 and 2, if a requirement is promulgated the AICPA's revised AT 501 standard should be the applicable standard, as this standard was specifically written for non-public companies – a category that would include credit unions.

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 internal control structure and procedures, or should each credit union have the option to choose its own standard?

The language in the preamble to PCAOB Auditing Standard No. 2 allows for appropriate choice, as follows: "Management is required to base its assessment of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework established by a body of experts that followed due process procedures" to develop the framework. In the United States, the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission has published Internal Control – Integrated Framework. In today's environment, COSO's publication (also referred to simply as COSO) provides a suitable framework for purposes of management's assessment and is the only internal control framework utilized by American companies. However, the possibility exists that another standard that meets the conditions specified in PCAOB Auditing Standard No. 2 could be developed at a later date.

10. Should the 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?

No. Under ideal circumstances the members of the Supervisory Committee would have the experience and expertise outlined in the question. However, given the limited membership constraint that many credit unions have and the fact that Supervisory Committee members are not compensated for their services, it would be difficult for many Supervisory Committees to meet this requirement. The experience standards expressed in the question should be an aspiration and not a requirement. Experience tells us that given the remarkable lack of financial reporting failure in the credit union environment, Supervisory Committees as presently formed are doing a respectable job of overseeing the financial reporting and internal control systems of credit unions. Alternatively, the NCUA should consider encouraging Supervisory Committee members to seek ongoing continuing educational opportunities offered in the credit union environment.

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?

Yes. Given the Supervisory Committee's responsibilities, it should be permitted to obtain whatever outside resources, including legal counsel, it feels are necessary to fulfill its responsibilities. All credit union Supervisory Committees, regardless of size, should be permitted this option.

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 Supervisory Committee must be independent and free of conflicts of interest. A corporate code of ethics should address the large customer situation described above. There should be no minimum asset size as this principle should apply to all Supervisory Committees regardless of credit union asset size.

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.

Question 10 includes the experience and expertise requirement. The response to Question 10 discussed the compensation and field of membership obstacles. The individuals who have the experience and expertise contemplated by the question have skill sets that are highly sought after in today's marketplace, and these individuals likely have significant demands on their available time. These individuals would also be most likely to understand the additional liability that an "audit committee" member has in today's corporate environment. Many credit unions are still associated with sponsor organizations and most members are employed by those sponsor organizations. The members who have the contemplated expertise are likely members of the sponsor's management team and typically have little volunteer time available. Both of these factors would conspire to limit the pool of a credit union's possible Supervisory Committee members. The requirements posed in questions 11 and 12 would pose minimal obstacles to credit unions.

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 the SEC's "independence" requirements and interpretations? If not both, why not?

1. The AICPA's "independence" standards should be adopted for the credit union environment because the SEC's independence standards were designed for the public company sector and address an environment that is profoundly different from the ones in which credit unions and their auditors operate. The SEC independence standard chiefly addresses the auditor dependence on one client risk and this risk does not exist in the credit union environment. The AICPA's independence standards adequately address the independence issues in the credit union environment.

    i. This issue revolves around auditor dependence on one client. Here again we see dramatic differences between the credit union and multi-conglomerate environments. In the multi-conglomerate environment, the audit partners involved in the engagement draw a significant part of their livelihood from a single client. Consider that in 2000, Enron paid their audit firm $25 million for the financial statement audit, and $27 million for consulting services. Consider that our firm serves approximately 700 credit union clients and receives gross fees from those 700 credit unions of $17 million, and we serve more credit union clients than any other CPA firm. Further, a partner in a typical audit firm is expected to manage about $2 million in total client fees per year. Therefore, Enron provided approximately 25 Arthur Andersen partners with their entire annual book of business; in other words, for the 25 Arthur Andersen partners who provided services to Enron, the entire source of their livelihood for the year 2000 was provided by Enron. When an audit partner's entire livelihood, and in this case it was multiple partners, is dependent upon a single client, that client could have considerable leverage on the auditor's independence and objectivity. In the public company environment, it is not difficult to understand why specific independence guidelines needed to be crafted to enhance auditor independence, and why SOX bluntly barred the independent auditor from performing certain consulting services. A much different situation exists in the non-public company environment which the AICPA's standards were crafted to address, and this is the environment in which credit unions operate. Therefore, the AICPA's independence standards are appropriate for credit union auditors and the Sarbanes Oxley standards are not.

    ii. Consider that our firm provides auditing and consulting services to over 700 credit unions. Our partners are expected to manage about $1.5 million in total client fees per year. On average, our partners each manage about 40 large clients per year. On average, our largest clients support only about 2.5% of a partner's total book of business. Our very largest client supports less than 10% of that partner's total book of business. Contrast this situation with the multi-conglomerate client providing 100% of not only one, but perhaps twenty-five partners' total book of business.

iii. The economic incentive for an auditor to ignore accounting principles to accommodate an aggressive client is very strong in the multi-conglomerate environment and very weak in the credit union environment. Credit unions by nature of their size do not present the single-client auditor independence risk that the Sarbanes Oxley Act focuses upon. Again, here is another reason why it would be a mistake for a credit union to apply to their environment a rule intended for the public company environment. Credit union auditors should not be barred from providing traditional consulting services. As described below, to do so would cause harm to the credit union community.

2. Should the NCUA impose the needlessly more restrictive public company SEC auditor independence standard, there will be significant and unnecessary costs and consequences for credit unions.

   i. Aside from the facts that clearly demonstrate the Sarbanes Oxley Act was not intended for the credit union environment, credit unions should consider that there are costs and unfavorable consequences if the NCUA decides to bar the independent auditor from providing traditional consulting services such as internal control consulting and data security.

   ii. When the auditor's firm also provides consulting services, the auditor derives the benefit of being able to draw upon the expertise of the consultants. The auditor can sharpen the audit focus and more deeply understand the internal control environment and strategic business issues in a manner that would otherwise not be possible. A better audit results from access to consultants who have also served the audit client. In fact, a former head of the SEC, Richard Breeden, has suggested that an audit firm that does not have access to the competencies that are typically derived from consultants, such as technology and internal control specialists, may not be qualified to audit an enterprise that makes extensive uses of technology driven delivery channels and sophisticated processes. Access to these competencies allows the auditor to plumb the depths in the client's organization and identify more subtle and complex business issues. This access contributes to a higher quality of assurance, and that means a better audit.

   iii. Consider also that the credit union industry is a highly-specialized niche that has unique operating characteristics and regulations. The choice of competent consulting firms in such a small, highly-specialized industry is very narrow. In fact, the same statement can be said of all middle-market businesses in America. The multi-conglomerates in the public company environment have a rich array of competent choices in obtaining consulting services, but this is not the case for credit unions, or other middle-market businesses. This fact alone has persuaded state legislators not to apply the new SEC law to credit unions and other middle-market businesses.

   iv. Because the choice is narrow in the middle-market and because the audit firm often offers customized services tailored to the industry, the legislators did not want to limit the choice for middle-market businesses. Eliminating the credit union audit firm from providing consulting services not only significantly narrows choice, because of the relatively small credit union industry sector, but it also often eliminates the most efficient and cost-effective choice. If the NCUA elects to eliminate the auditor from consideration in providing these services, credit unions will, in many cases, have to turn to less qualified, less experienced, less effective and more expensive companies.

v. Audit quality and choice of consulting resources are two of the most important cost and consequence issues that must be considered if your credit union is required to exclude the independent auditor from performing consulting services.

3. For an additional perspective on auditor independence consider the following reality check.

   i. It is important for those responsible for overseeing credit union corporate governance to fully understand "independence" as it relates to the auditor. In reality, no auditor is ever "independent" for the simple fact that the credit union pays the audit fee. Therein lies a fundamental and inherent conflict of interests that assures that no matter what is done, short of government employees conducting audits, auditor independence will never be perfect. It will always be a balancing act with compensating controls being implemented to assure that a reasonable and rational level of independence is maintained. Boards and Management who attempt to achieve immaculate independence will ultimately be frustrated and disappointed. Boards who believe Sarbanes Oxley is a silver bullet solution to independence are understandably but unfortunately mistaken. Independence will always be a balancing act and there will always be compromises. It is essential that as credit unions and their regulators review the Sarbanes-Oxley issue and corporate governance policy they impound this reality into the process.

4. If the NCUA decides to impose SEC type independence standards consider the following alternative approach to protecting auditor independence.

   i. If the NCUA decides it must impose SEC type auditor independence standards, while we believe this in unnecessary and imposes needless costs and consequences on credit unions, we offer an alternative approach that directly addresses this segment of auditor independence risk. The premise of this approach is that the compromising of independence standards that took place at Enron and other public companies was primarily caused by the impact that the total amount of fees charged to a particular client has on that partner's independence; and that impact is directly proportional to the percent of a partner's annual book of business that client represents.

   ii. Our proposal is that if the CPA is performing consulting and other services in addition to audit services <u>and</u> if total fees from the CPA firm <u>exceed</u> a specified threshold, then it would be deemed that auditor independence is at risk and the provisions of the Sarbanes Oxley act would be applied. This approach recognizes that there is some threshold of consulting services below which it is reasonable to assume that only negligible independence risk exists. The cost of this negligible risk is more than offset by the consulting service efficiencies and audit quality efficiencies gained when the same firm performs these services. The use of a threshold is not a new concept, as the NCUA has frequently used thresholds to determine if a particular regulation should be applied.

iii. We propose that the combined fee threshold be in the $300,000 per partner range. If audit and consulting fees exceed $300,000 the auditor independence provisions of the Sarbanes Oxley act would be triggered. The $300,000 threshold amount should be periodically adjusted for inflation.

iv. We estimate that $300,000 in fees would represent no more than 10% to 20% of the total book of business of a CPA partner who serves the credit union niche, and in cases where there is more than one partner involved in the engagement, the livelihood percentage would be even less than 10%. It is important to recognize that a total client fee of $300,000 produces only about $30,000 in income to the partner after staff compensation and operating expenses are paid. The likelihood that a CPA would bet their professional career on a client who was producing such a small portion of their livelihood, in the case of this example, $30,000, is remote.

v. We believe our proposal properly distinguishes the credit union environment from the public company environment while adopting the provisions of the Sarbanes Oxley Act at a point where auditor independence risk reaches a level of concern. In essence, our proposal defines a risk-based regulation.

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?

There is some value in retaining the balance sheet audit. Some credit unions believe this presents a good cost/benefit equation to them. The traditional opinion audit on all the financial statements provides more value to the credit union as third party consumers of the credit union's audited financial statements typically expect the traditional opinion audit. The vast majority of our clients who receive opinion audits, both large and small credit unions, prefer the standard opinion audit on all the financial statements over the opinion audit of the balance sheet only.

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?

The "*Supervisory Committee Guide* audit," also known as an "agreed upon procedures audit," provides value to credit unions with less than $500 million in assets. The flexibility and focus this audit allows can produce cost effective value to smaller, less complex, financially healthy credit unions. The challenge the NCUA has with this regulatory option is to assure that the non State-licensed consultant who provides these services is adequately trained and possesses the required expertise and audit skills to accomplish the objectives of the audit and that the audit workpapers reflect that a competent audit was performed.

17. Should part 715 require credit unions that obtain a financial statement audit and/or an "attestation on internal controls" (whether 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?

It should not be burdensome for the credit union to forward a copy of these reports to the NCUA. Under normal circumstances, the current time period of 120 days is sufficient. However, a six-month deadline from the effective date of the audit would present a credit union with a valuable cost-effective audit option. This additional period of time would allow a credit union with an audit effective date of December 31 to have the audit fieldwork completed subsequent to April 1, the auditors' "non busy season," and have the report finalized and forwarded to the NCUA by June 30. Credit unions who take this approach would likely receive a discounted audit fee because it would enable the auditor to spread their client work load for December 31 audits, which is by far the busiest time of the year for every auditor, over a longer period of time. Auditors would be willing to share this benefit with their client in the form of a reduced audit fee.

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?

See response to question 17 as to the time frame by which these reports would be issued. The NCUA should specify what it means by the term "qualification." If the term means qualification of an opinion, then that necessarily would be part of the financial statement audit discussed in question 17 and would not be issued as a separate statement. The NCUA should also specify what it means by the term "other report." It is recommended that only communications that contain reportable conditions or their equivalent be forwarded to the NCUA. The other less significant comments would be included in an audit memorandum that would not be forwarded to the NCUA. However, these less significant comments would be available to the examiner during the field examination. There is always heightened sensitivity when a report is sent to the NCUA; not requiring less significant comments to be forwarded would probably result in more robust audit memorandum comments, as the credit unions would feel less pressure to contest the inclusion of these helpful comments in a memorandum that is not forwarded to the NCUA. However, the audit memorandum would be available for the examiner to review in the field.

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 the NCUA?

The auditor should, as a matter of course, review with the Supervisory Committee the content of the reports and this should be done before the credit union forwards those reports to the NCUA.

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?

For the same reasons enumerated in the response to question 17, the target should be extended to the end of the sixth month after the audit effective date. The target date could be further extended under certain circumstances that are beyond the credit union's and the auditor's control. Sanctions should be modest because in our experience untimely audited financial statements are typically caused by reasons that are beyond the credit union's and the auditor's control. Computer system failures, fraud and third-party failure to produce records that are instrumental to the audit, are examples of causes of untimely audited financial statements over which the credit union and the auditor often have little control.

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?

It is difficult to ascertain the benefit that would be derived from after-the-fact notice that a credit union has selected a particular auditor. However, notice of an auditor's dismissal or resignation could be beneficial to the regulator if perspective on the underlying reasons for the dismissal or resignation is obtained by the regulator from both the credit union and the auditor.

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 subject of engagement letters containing language that limits various forms of auditor liability has been addressed by the AICPA and the FFIEC. The statements included within question 22 represent common ground that has been agreed to by the regulators and the auditing profession. This area is relatively complex, as auditor independence is an issue. Any language the Supervisory Committee wishes to use in order to increase or decrease auditor liability should be reviewed by individuals having expertise in auditor independence and audit standards before the engagement letter is executed.

Respectfully submitted,

Eugene A. O'Rourke

Eugene A. O'Rourke, Partner
McGladrey & Pullen
Response Reg Rulemaking SC Audits 04-18-06 EOR.se