

# Proposed Rules

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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

## NATIONAL CREDIT UNION ADMINISTRATION

### 12 CFR Part 701

#### Supervisory Committee Audits and Verifications

**AGENCY:** National Credit Union Administration (NCUA).

**ACTION:** Proposed rule.

**SUMMARY:** The National Credit Union Administration (NCUA) is proposing to amend its regulations governing credit union supervisory committee audits and verifications. The NCUA Board is proposing to amend the regulations to clarify existing audit scope; expand audit scope and reporting requirements in certain areas; clarify existing working paper access requirements and strengthen administrative remedies for denial of access; require a comprehensive engagement letter setting forth minimum contracting terms and conditions; and add relevant definitions of accounting/auditing terms used throughout the regulation.

**DATES:** Comments must be received on or before January 2, 1996.

**ADDRESSES:** Send comments to Becky Baker, Secretary of the Board, National Credit Union Administration Board, 1775 Duke Street, Alexandria, VA 22314-3428.

**FOR FURTHER INFORMATION CONTACT:** Karen Kelbly, Accounting Officer, Office of Examination and Insurance (703) 518-6360, or Michael McKenna, Attorney, Office of General Counsel (703) 518-6540, at the above address.

#### SUPPLEMENTARY INFORMATION:

##### Background

On March 25, 1993, the NCUA Board issued for public comment a proposed amendment to the "then" supervisory committee audit and verification requirements. Two hundred two comment letters were received over a 60-day comment period which ended June 7, 1993. Thirty-one commenters gave their full support of the

amendment as written; fifty-three commenters offered mixed support; and one hundred eighteen commenters opposed the amendment.

In their final amendment, the NCUA Board changed the regulations governing supervisory committee audits and verification to: (1) Add a nonstatistical sampling option for independent, licensed, certified public accountants in the verification of members' accounts consistent with applicable generally accepted auditing standards (GAAS); and (2) change applicable sections of the "then" regulation to more properly reflect accounting/auditing terms of art without otherwise changing the intent of the regulation. Dropped from consideration in the final amendment were the proposed amendments to require independent annual audits (opinion audits) for federally insured credit unions with assets exceeding \$50 million, and to require that the supervisory committee and/or its auditors provide NCUA the option to photocopy working papers supporting the audit.

Since July 1993 when § 701.12 was last amended, NCUA has had continued concerns about the scope of the supervisory committee audit. Many of these concerns are outlined in specific detail below. Rather than again proposing an amendment for an opinion audit requirement, which many commenters soundly rejected in their comment letters on the last proposed amendment, the Board wishes to solicit views on a proposed revision to the current regulation which expands audit scope without requiring an opinion audit. This proposal is an opportunity to consider a middle ground approach, with the goal of building a consensus that both the regulated and the regulator would find agreeable.

Currently, § 701.12, 12 C.F.R. 701.12, sets forth the supervisory committee's responsibility in meeting the audit and verification requirements of section 115 of the Federal Credit Union Act, 12 U.S.C. 1761d. A supervisory committee audit is required at least once every calendar year covering the period since the last audit. The scope of the audit must be sufficient, at a minimum, to test the federal credit union's assets, liabilities, equity, income, and expenses for existence, proper cut off, valuations, ownership, disclosures and

classification, and internal controls (current § 701.12(b)). A written report on the audit must be made to the board of directors and, if requested, NCUA (current § 701.12(c)). Working papers must be maintained and made available to NCUA (current § 701.12(c)). Independence requirements must be met (current § 701.12(d)); standards governing verifications—100 percent verification or statistical sampling—are set forth (current § 701.12(e)). Section 741.2 makes these requirements applicable to federally insured state-chartered credit unions.

The proposed regulation will address practical enforcement problems in the existing regulation, some of which have arisen through the examination process as a matter of course and others of which have arisen in litigation and in negotiating settlements. The proposed changes in audit scope represent increased requirements which the Board believes have grown out of necessity. The scope changes are more specific and are aimed at eliminating vagueness regarding the audit scope required, in certain targeted risk areas, to meet the provisions of this regulation. The vagueness of audit scope has been the subject of complaints from both the regulated and the regulator/insurer.

The majority of added requirements are not applicable to credit unions which do not employ a compensated auditor. If the supervisory committee or an uncompensated designated representative will be performing the supervisory committee audit as described in § 701.12(4)(iv), the following portions of the proposed regulation *do not apply* to the supervisory committee audit: § 701.12(c)(3) [increased scope requirements in designated areas]; § 701.12(4)(i)(A)–(C) [opinion audits and agreed-upon-procedures in relation to compensated auditors]; and § 701.12(d) [engagement letter requirements].

#### Proposed Regulation

Added to the first part of proposed § 701.12(a) is a set of definitions for terms used in the regulation. Many of these terms, while familiar to accounting/auditing professionals, may be less well known to supervisory committee volunteers. For example, the definition of "audit" is intended to closely follow the language in AICPA, Professional Standards, volume 1, AU

section 110.01; the definition of "independence" is intended to be consistent with Rule 101 of the AICPA Code of Professional Conduct; the definition of "related party transactions" is intended to be consistent with FASB Statement No. 57; and the definition of "internal control reportable conditions" is intended to be consistent with Statement of Auditing Standard (SAS) No. 60, Communication of Internal Control Structure Related Matters Noted in an Audit (AICPA, Professional Standards, volume 1, AU section 325).

Additionally, as concerns "independence," the auditor must be intellectually honest and be recognized as independent, i.e., free from any material obligation to or interest in the credit union or its officials. The independent auditor must enjoy the confidence of the general public. Such confidence may be compromised by evidence that independence is lacking, or by the existence of circumstances which reasonable people might believe likely to influence independence. The definition of "related party transactions" uses as examples of senior management the chief executive officer (CEO), president, treasurer/manager, assistant CEO, and the chief financial officer (Comptroller) of a credit union, and their families, etc. However, this is not intended to be an all inclusive list of related parties.

The proposed definitions rely on accepted supplemental references, e.g., a reference for the definition of "generally accepted accounting principles" is SAS No. 69, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles"* in the Independent Auditor's Report which establishes a GAAP hierarchy (GAAP serves to provide a standard by which to measure financial statement presentations); a reference for the definition of "internal controls" is Internal Control—Integrated Framework, published by the Committee of Sponsoring Organizations of the Treadway Commission; and a reference for the definition of "illegal acts" is SAS No. 54, *Illegal Acts By Clients*, (AICPA, Professional Standards, volume 1 AU section 317). The definitions section was added to elucidate terms used in the regulation. The NCUA Board seeks comments as to whether the definitions clarify the regulation. The NCUA Board also is interested to learn of any additional terms which should be defined in the regulation.

Subsections 701.12(b)(1), (b)(2), and (c)(1), (c)(2) of the proposed regulation represent a reordering of the existing

regulatory provisions with minor changes in language which are intended not to change, but to clarify, the existing regulation's meaning or provisions. However, the supervisory committee is expected to conduct such further tests and reviews as may, in the committee's judgment, be necessary to meet its responsibilities. Additionally, the changes incorporate in part enhancements suggested by the American Institute of Certified Public Accountants, Credit Unions Committee ("the AICPA Committee"). The AICPA Committee reviewed the proposed regulation for technical accuracy of usage of accounting/auditing technical terms and concepts. NCUA is grateful to the AICPA Committee for its advice during the drafting of the proposed regulation.

The audit scope changes added to § 701.12(c)(3) expand the required audit scope when a supervisory committee employs the services of a compensated auditor. The additional requirements are not intended to discourage a credit union from hiring a compensated auditor, but are intended to achieve a more definitive audit scope in targeted areas, which experience indicates are of higher risk in credit unions. The AICPA audit guide, *Audits of Credit Unions*, prepared by the AICPA Credit Unions Committee, is a proper reference for the auditor in making judgments, based on the facts and circumstances of the engagement, as to what procedures to perform to obtain sufficient, competent evidential matter to afford a reasonable basis for conclusions regarding the financial statements under audit. The NCUA Board believes the expanded scope will provide those credit unions having the resources to employ a compensated auditor with an enhanced audit product that meets the applicable GAAS requirements of an opinion audit in the following areas: internal controls; cash; loans and interest thereon; investments and interest thereon; shares and dividends and/or interest thereon; related party transactions; and the detection and reporting of errors and irregularities. NCUA believes this increased scope requirement not only will give the credit union a greater return on the dollars invested in the audit, but will result in a more useful audit report for the examiner, whether regulator or insurer.

The more definitive audit scope is designed to address and to reduce confusion which occurs when the supervisory committee and the compensated auditor agree that the audit engagement will consist of less than the full scope of a supervisory committee audit as prescribed in 701.12

(b) and (c). Experience indicates that supervisory committees often do not realize that, due to the compensated auditor's exclusion of scope provisions (e.g., evaluation of the reasonableness of the allowance for loan losses, evaluation of securities held, adequacy of loan collateral, etc.), the final audit product is not a complete supervisory committee audit. Nor do supervisory committees realize that in such instances they remain responsible for performing the additional audit work needed to "fill the gaps" and produce a complete supervisory committee audit. The NCUA Board believes that vagueness in the existing audit scope provision may have contributed to the confusion, and that a more definitive audit scope will end the finger pointing between supervisory committees and compensated auditors as to who is responsible for the audit scope components excluded from the audit engagement.

To further reduce confusion about responsibility for required scope components that are excluded from the audit engagement, the NCUA Board has added a requirement in § 701.12 (d)(2) and (d)(3) for the engagement letter between the supervisory committee and the compensated auditor to address audit scope either by (1) certifying that the compensated auditor is to complete the full scope of a supervisory committee audit or, alternatively (2) specifying what prescribed financial statement elements and/or attributes will be excluded from the engagement, and expressly cautioning the supervisory committee that it is responsible for fulfilling the scope of the supervisory committee audit with respect to the excluded elements and attributes.

The additions to § 701.12(c)(4) of the proposed regulation set forth how the requirements of this part may be satisfied. The revisions, like those discussed above, represent minor changes in language which are not intended to change the existing regulation's meaning or provisions. Instead, the revisions incorporate technical improvements suggested by the AICPA Committee. The additional requirement that the compensated auditors contract for the audit engagement only with the supervisory committee and return the written audit report(s) to the supervisory committee clarifies requirements contained in the current regulation.

The NCUA Board had considered including a requirement in the proposed regulation's audit scope for certain credit unions to have an ongoing internal audit function in the form of

either an internal auditor or an internal audit department. Such a function would benefit the credit union, the regulator, and the insurer. Internal auditors would neither take the place nor diminish the role of the supervisory committee in any way. Ideally, the internal auditor would be hired by, receive instructions from, and report to, the supervisory committee. The work of the internal auditor would supplement the mandated role and responsibilities of the supervisory committee. Although the NCUA Board has decided against requiring credit unions to employ an internal auditor, it encourages credit unions that have the resources, to consider the benefits of employing an internal auditor (e.g., testing of the effectiveness of internal controls on an interim and/or on-going basis; routine and on-going testing for material errors and omissions, and irregularities and illegal acts; continuous testing of the electronic data processing system for reliance thereon; and improving economy and efficiency). Internal auditors can play an important role in maintaining strong operational and financial management controls. The NCUA Board invites comments as to whether it should reconsider mandating an internal audit function and, if so, whether such a requirement should be imposed on all or only some credit unions, and on what basis, i.e., according to asset size, complexity of services, etc.

The NCUA Board is inclined to add requirements in § 701.12(d) for credit unions which employ compensated auditors to memorialize the terms and conditions of the engagement in a comprehensive engagement letter, which constitutes an enforceable contract between the compensated auditor and the supervisory committee. The proposed regulation sets forth the minimum requirement of an audit engagement to be addressed in such a letter. The majority of items required are fairly consistent with standard items included in engagement letters as used in current practice: terms and objectives of engagement; nature and limitations; identification of the basis of accounting to be used; identification of areas excluded from the scope; and an appendix setting forth the procedures to be performed (if not an opinion audit). Other requirements were added to ensure access by NCUA to a complete set of original working papers and delivery of the required report(s) to the supervisory committee within a reasonable period of time. The NCUA Board seeks comment on any additional areas which should be addressed in the

engagement letter memorializing the terms and conditions of the audit engagement.

Additional reporting requirements have been added in § 701.12(e)(1). Along with the existing requirement for a written audit report is a requirement for two additional written reports where applicable—a written report of internal control exceptions or reportable conditions noted, if any, and a written report of irregularities or illegal acts noted during the audit, if any. The addition of these two reporting requirements does not necessitate additional audit work (i.e., do not require separate engagements to report on the credit union's system of internal accounting control or its compliance with laws and regulations). These are simply reports of information already obtained in the normal course of the supervisory committee audit. This requirement corrects the current regulation, which does not require such reports to be communicated to either the credit union, the regulator, or the insurer.

A clarifying sentence was added to § 701.12(e)(2) to ensure that NCUA access to a complete set of original working papers includes all the existing documentation relative to the audit: audit programs, working papers documenting conclusions or judgments, supervisory reviewer's notes (if any), etc. This is a response to increasing instances where NCUA examiners find that information deemed by the auditor to be "proprietary information" is excluded from the working papers. The exclusion of this additional and pertinent documentation (e.g., audit programs) impairs NCUA's ability to assess the adequacy of the work performed by the auditor to satisfy the requirements of this section. Proposed § 701.12(d)(1)(vii) requires the supervisory committee to incorporate in the comprehensive engagement letter a certification by the outside compensated auditors that a complete set of original working papers supporting the audit, including the audit program, will be provided upon request for inspection by NCUA.

Finally, the NCUA Board has added an enforcement mechanism to ensure compliance with the requirements of this section and with the requirements of the comprehensive engagement letter memorializing the audit engagement between the supervisory committee and its compensated auditor. In the event of failure to comply, proposed § 701.12(e)(3) authorizes the Regional Director, as a first step toward enforcement, to reject as deficient the supervisory committee audit and the

reports thereof. An additional and more severe sanction for failure to comply is available under section 206(r) of the FCU Act, 12 U.S.C. 1786(r), which authorizes NCUA to seek formal administrative sanctions (e.g., an order to cease and desist, or imposition of civil money penalties) against the supervisory committee and/or its compensated auditor as "institution affiliated parties" of the credit union.

Parts of the existing regulation relating to the independence and verification of members' accounts were unchanged in substance, although redesignated as subsections 701.12 (f) and (g), respectively.

One change to part 701.13 was made to give recognition to the redesignation of old § 701.12(e) to new § 701.12(g).

#### Regulatory Procedures

##### *Regulatory Flexibility Act*

The Regulatory Flexibility Act requires NCUA to prepare an analysis to describe any significant economic impact a proposed regulation may have on a substantial number of small credit unions (primarily those under \$1 million in assets). The NCUA Board has determined and certifies that the proposed amendment, if adopted, will not have a significant economic impact on a substantial number of small credit unions. As to small credit unions, the proposed amendment clarifies without imposing additional burden. Accordingly, the NCUA Board determines and certifies that this proposed amendment does not have a significant economic impact on a substantial number of small credit unions and that a Regulatory Flexibility Analysis is not required.

##### *Paperwork Reduction Act*

NCUA has determined that the three requirements: (1) to prepare and sign an engagement letter memorializing the terms and conditions of the audit engagement in a comprehensive engagement letter, which constitutes an enforceable contract between the compensated auditor and the supervisory committee; (2) to provide a written report of internal control exceptions or reportable conditions noted, if any; and (3) to provide a written report of irregularities or illegal acts noted during the audit, if any; do constitute a collection of information under the Paperwork Reduction Act. The Paperwork Reduction Act of 1995 and regulations of the Office of Management and Budget (OMB) require that the public be provided an opportunity to comment on information collection requirements, including an

agency's estimate of the burden of the collection of information. NCUA estimates that most federal credit unions will be affected by this regulation. However, it is the NCUA's view that the time a credit union spends developing an enforceable engagement contract and provides in writing, known internal control exceptions and reportable conditions, if any, and/or irregularities and illegal acts, if any, is necessary to the effectiveness of the audit and verification function and thus, the safety and soundness of the credit union. The paperwork burden created by this rule is the requirement that such actions be put in writing. NCUA estimates that it should reasonably take one hour per requirement (thus, 1 hour minimum—3 hours maximum) to comply with the three requirements, if applicable to a given circumstance. Therefore, 12,000–36,000 total burden hours are required to comply with the collection requirement. For the majority of credit unions, 1 hour would be required, or 12,000 total burden hours.

The NCUA Board invites comment on: (1) whether the collection of the information is necessary for the proper performance of the functions of NCUA, including whether the information will have practical utility; (2) the accuracy of NCUA's estimate of the burden of the collection of information; (3) ways to enhance the quality, utility, and clarity of the information to be collected; and (4) ways to minimize the burden of collection of information. Send comments to Attn: Milo Sunderhaug, OMB Reports Management Branch, New Executive Office Building, Rm. 10202, Washington, DC 20530.

#### *Executive Order 12612*

Executive Order 12612 requires NCUA to consider the effect of its actions on state interests. The proposed amendment will not have a substantial direct effect on the states, on the relationship between the national government and the states, or on the distribution of rights and responsibilities among the various levels of government.

#### List of Subjects in 12 CFR Part 701

Credit unions, Reporting and recordkeeping requirements.

By the National Credit Union Administration Board on October 19, 1995.  
James Engel,  
*Acting Secretary of the Board.*

Accordingly, it is proposed that 12 CFR, part 701 be amended to read as set forth below:

#### **PART 701—[AMENDED]**

1. The authority citation for Part 701 continues to read as follows:

Authority: 12 U.S.C. 1752(5), 1755, 1756, 1757, 1759, 1761a, 1761b, 1766, 1767, 1782, 1784, 1787, 1789, 1798 and Public Law 101–73. Section 701.6 is also authorized by 31 U.S.C. 3717. Section 701.31 is also authorized by 15 U.S.C. 1601, *et seq.*, 42 U.S.C. 1981 and 42 U.S.C. 3601–3610.

2. Section 701.12 is amended by redesignating paragraphs (d) and (e) as paragraphs (f) and (g), by revising paragraphs (a) through (c), and by adding new paragraphs (d) and (e) to read as follows:

#### **§ 701.12 Supervisory committee audits and verifications.**

(a) *Definitions.* As used in this chapter:

(1) *Agreed-upon procedures* means the performance by an independent, licensed certified public accountant of an engagement in which the scope is limited to applying specified agreed-upon procedures to one or more specified elements, accounts, or items of a financial statement. Such procedures are insufficient to express an opinion regarding either the financial statements taken as a whole, or the specified elements, accounts, or items.

(2) *Applicable generally accepted auditing standards (GAAS)* means generally accepted auditing standards to the extent applicable in the circumstances. The second general standard of GAAS relating to independence and the four standards relating to reporting are not applicable to a compensated auditor who is not an "independent, licensed, certified public accountant" as defined in paragraph (a)(9) of this section; all other requirements of GAAS would apply to such an auditor.

(3) *Audit or Opinion audit* means an examination of the financial statements performed by an independent, licensed, certified public accountant in accordance with generally accepted auditing standards. The objective of an "audit" or "opinion audit" is to express an opinion as to whether those financial statements present fairly, in all material respects, the financial position and the results of its operations and its cash flows in conformity with generally accepted accounting principles or an "other comprehensive basis of accounting," as defined in paragraph (a)(11) of this section.

(4) *Compensated auditor* means any accounting/auditing professional who is compensated for performing the supervisory committee audit and/or verification services.

(5) *Financial statements* means a presentation of financial data, including accompanying notes, derived from accounting records of the credit union, and intended to disclose a credit union's economic resources or obligations at a point in time, or the changes therein for a period of time, in conformity with generally accepted accounting principles (GAAP) or an "other comprehensive basis of accounting," as defined in paragraph (a)(11) of this section. Each of the following is considered to be a financial statement: a balance sheet or statement of financial condition; statement of income or statement of operations; statement of retained earnings; statement of cash flows; statement of changes in owners' equity; statement of assets and liabilities that does not include owners' equity accounts; statement of revenue and expenses; summary of operations; and statement of cash receipts and disbursements.

(6) *Generally accepted accounting principles (GAAP)* means the conventions, rules, and procedures which define accepted accounting practice. GAAP includes both broad general guidelines and detailed practices and procedures, provides a standard by which to measure financial statement presentations, and encompasses not only accounting principles and practices but also the methods of applying them.

(7) *Generally accepted auditing standards (GAAS)* means the standards approved and adopted by the American Institute of Certified Public Accountants which apply when an "independent, licensed certified public accountant" audits financial statements. Auditing standards differ from auditing procedures in that "procedures" address acts to be performed, whereas "standards" measure the quality of the performance of those acts and the objectives to be achieved by use of the procedures undertaken. In addition, auditing standards address the auditor's professional qualifications as well as the judgment exercised in performing the audit and in preparing the report of the audit. Copies of GAAS may be obtained from Harcourt Brace & Co., 6277 Sea Harbor Drive, Orlando, FL 32887.

(8) *Independence and Independent* means to be without bias with respect to the credit union so as to maintain the impartiality necessary for the reliability of the compensated auditor's findings. Independence requires the exercise of fairness toward credit union management, members, creditors and others who may rely upon the independent, compensated auditor's

report. Auditors must be independent in fact and in appearance.

(9) *Independent, licensed, certified public accountant* means an individual who has passed the Uniform Certified Public Accounting Examination, is licensed by a state board of accountancy to practice accounting/auditing, and is independent as defined in paragraph (a)(8) of this section.

(10) *Internal controls* means the process, established by the credit union's board of directors, officers and employees, designed to provide reasonable assurance of reliable financial reporting and safeguarding of assets against unauthorized acquisition, use, or disposition. A credit union's internal control structure consists of five components: control environment; risk assessment; control activities; information and communication; and monitoring. Reliable financial reporting refers to preparation of financial statements that "present fairly" the financial position and results of its operations and its cash flows, in conformity with GAAP or an "other comprehensive basis of accounting," as defined in paragraph (a)(11) of this section. Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition refers to prevention or timely detection of transactions involving such unauthorized access, use, or disposition of assets which could result in a loss which is material to the financial statements.

(11) *Other comprehensive basis of accounting* means a comprehensive basis of accounting or definite set of criteria, other than GAAP, having substantial support. In this case the "other comprehensive basis of accounting" is limited to applicable regulatory accounting practices (RAP), i.e., that basis of accounting which has the substantial support of NCUA or the state supervisor, when applicable.

(12) *Related party transactions* means transactions among or between parties where one party controls or can significantly influence the management or operating policies of the other so as to prevent the other party from pursuing exclusively its own interests. Examples of related parties include: credit union members and their families, and credit union officials and their families. Examples of "related party transactions" include: interest-free loans or loans at below market rates; sale of real estate significantly below appraised value; nonmonetary exchange of property; and making of loans lacking scheduled terms for repayment.

(13) *Reportable Conditions* means a matter coming to the compensated

auditor's attention that, in his or her judgment, represents a significant deficiency in the design or operation of the internal control structure of the credit union, which could adversely affect its ability to record, process, summarize, and report financial data consistent with the representations of management in the financial statements.

(14) *Substantive testing* means testing of details and analytical procedures to detect material misstatements in the account balance, transaction class, and disclosure components of financial statements.

(15) *Supervisory committee* means a supervisory committee as defined in Section 111(b) of the Federal Credit Union Act, 12 U.S.C. 1761(b). For some federally-insured state chartered credit unions, the "audit committee" designated by state statute or regulation is the equivalent of a supervisory committee.

(16) *Supervisory committee audit* means an examination of the credit union's financial statements in accordance with applicable GAAS, which is performed by the supervisory committee or its designated representative as prescribed in paragraph (c)(4) of this section. An audit as defined in paragraph (a)(3) of this section satisfies the definition of a "supervisory committee audit."

(17) *Working papers* means the principal record, in any form, of the work performed by the auditor and/or supervisory committee to support its findings and/or conclusions concerning significant matters. Examples include the written record of procedures applied, tests performed, information obtained, and pertinent conclusions reached in the engagement, audit programs, analyses, memoranda, letters of confirmation and representation, abstracts of credit union documents, reviewer's notes, if retained, and schedules or commentaries prepared or obtained by the independent, compensated auditor.

(b) *Supervisory committee responsibilities.* (1) The supervisory committee is responsible for ensuring that:

(i) The credit union's financial statements, taken as a whole, fairly present, in all material respects, the financial position, the results of its operations and its cash flows, in conformity with GAAP or an "other comprehensive basis of accounting," although this requirement should not be interpreted to necessarily require an opinion audit.

(ii) The credit union's management practices and procedures are sufficient to safeguard members' assets.

(2)(i) To satisfy the requirements of paragraph (b)(1) of this section, the supervisory committee shall determine whether:

(A) Internal controls are established and effectively maintained to achieve the credit union's financial reporting objectives which, at a minimum, must support the satisfaction of the requirements of paragraphs (b) and (c) of this section;

(B) The credit union's accounting records and financial reports are promptly prepared and accurately reflect operations and results;

(C) The plans, policies, and control procedures established by the board of directors are properly administered; and

(D) Policies and control procedures are sufficient to safeguard against error, carelessness, conflict of interest, self-dealing and fraud.

(ii) The audit and verification of members' accounts, as mandated in Section 115 of the Federal Credit Union Act, 12 U.S.C. 1761d, are the minimum requirements for satisfying this paragraph (b).

(c) *Supervisory committee audit.* (1) A supervisory committee audit of each Federal credit union's financial statements shall occur at least once every calendar year and shall cover the period elapsed since the last audit. The supervisory committee audit shall be made by the supervisory committee or its designated representative, as described in paragraph (c)(4) of this section, using applicable GAAS.

(2) The scope of the supervisory committee audit shall include:

(i) Gaining an understanding of the internal control structure;

(ii) Assessing the level of control risk; and

(iii) Based on paragraph (c)(2)(ii) of this section, determining the nature, timing, and extent of substantive testing necessary to confirm the assertions made by management, in the financial statements, regarding each of assets, liabilities, equity, income, and expenses for the following attributes:

(A) Existence or occurrence;

(B) Completeness;

(C) Valuation or allocation;

(D) Rights and obligations; and

(E) Presentation and disclosures.

(3) For the compensated auditor, audit testing of the following areas must satisfy applicable GAAS for expressing an opinion on the financial statements taken as a whole: internal controls, cash, loans and interest thereon, investments and interest thereon, shares and dividends and/or interest thereon, related party transactions, and the detection and reporting of errors and irregularities with regard to each of these areas.

(4)(i) The requirements of the annual supervisory committee audit may be satisfied by one or more of the following:

(A) An audit of the credit union's financial statements performed by an independent, licensed, certified public accountant in accordance with GAAS;

(B) An "agreed-upon procedures engagement" performed by an independent, licensed, certified public accountant in accordance with applicable GAAS, which by itself or in combination with procedures performed by the supervisory committee, fulfills the required scope of the supervisory committee audit;

(C) A supervisory committee audit performed by an independent, compensated auditor other than an independent, licensed, certified public accountant in accordance with applicable GAAS, which by itself or in combination with procedures performed by the supervisory committee, fulfills the scope of a supervisory committee audit; or

(D) A supervisory committee audit by the supervisory committee or its designated, uncompensated representative, performed in accordance with applicable GAAS.

(ii) In all cases, an independent, compensated auditor is required to contract directly with the supervisory committee for the audit engagement and to deliver its written reports directly to the supervisory committee.

(d) *Engagement letter.* (1) The engagement of a compensated auditor to perform all or part of the scope of a supervisory committee audit shall be evidenced by an engagement letter. The engagement letter shall be signed by the compensated auditor and acknowledged therein by the supervisory committee prior to commencement of a supervisory committee audit. The engagement letter shall:

(i) Specify the terms, conditions, and objectives of engagement;

(ii) Identify the basis of accounting to be used, e.g., GAAP or an "other comprehensive basis" as defined in paragraph (a)(11) of this section;

(iii) Include an appendix setting forth the procedures to be performed (if not an opinion audit);

(iv) Specify the compensation to be paid for audit;

(v) Provide that the auditor shall, upon completion of the engagement, deliver to the supervisory committee written reports. All such reports may be based on work performed during the normal course of the audit; separate engagements are not required to report on the credit union's system of internal accounting control or its compliance

with laws and regulations. The written reports shall consist of:

(A) The supervisory committee audit;

(B) Any internal control exceptions or reportable conditions noted in the internal control review phase of the audit; and

(C) Any irregularities or illegal acts noted during the audit;

(vi) Specify a date of delivery of the written reports required by paragraph (d)(1)(v) of this section; and

(vii) In the case of a compensated auditor, certify that NCUA staff or its designated representative will be provided unconditional access to a complete set of original working papers, as defined in paragraph (a)(17) of this section, either at the credit union or at a mutually agreeable location.

(2) In the case of a supervisory committee audit engagement which will address all of the financial statement elements and attributes prescribed in paragraph (c)(2) of this section, the engagement letter shall, in addition to the requirements of paragraph (d)(1) of this section, include a certification that the audit is a complete supervisory committee audit.

(3)(i) In the case of a supervisory committee audit engagement which will exclude any financial statement elements and attributes prescribed in paragraph (c)(2) of this section, the engagement letter shall, in addition to requirements of paragraph (d)(1) of this section:

(A) Specifically identify the elements and attributes excluded from the audit;

(B) State that, because of the exclusion(s), the resulting audit will not, in and of itself, fulfill the scope of a supervisory committee audit; and

(C) Caution that the supervisory committee will remain responsible for fulfilling the scope of a supervisory committee audit with respect to the excluded elements and attributes.

(ii) A compensated audit fully satisfies the requirements of a supervisory committee audit when it meets the requirements of paragraphs (b) and (c)(1) of this section and addresses all of the financial statement elements and attributes prescribed in paragraphs (c)(2) and (c)(3) of this section.

(e) *Audit reports and working paper access.* (1) Upon completion or receipt of the supervisory committee audit reports prescribed in paragraph (d)(1)(v) of this section, the supervisory committee shall provide the reports to the board of directors. The supervisory committee shall ensure that the compensated auditor and its reports comply with the terms of the engagement letter prescribed by

paragraph (d) of this section. The supervisory committee shall, upon request, provide to the National Credit Union Administration a copy of each of the written reports received from the auditor.

(2) The supervisory committee shall be responsible for preparing and maintaining, or making available, a complete set of original working papers (as defined in paragraph (a)(17) of this section) supporting each supervisory committee audit. The supervisory committee shall, upon request, provide NCUA staff unconditional access to such complete set of original working papers either at the offices of the credit union or at a mutually agreeable location.

(3) Failure of a supervisory committee and/or its compensated auditor to comply with the requirements of this section, or the terms of an engagement letter required by this section, may be grounds for:

(i) The Regional Director to reject the supervisory committee audit; and

(ii) The NCUA to seek formal administrative sanctions against the supervisory committee and/or its compensated auditor pursuant to section 206(r) of the FCU Act, 12 U.S.C. 1786(r).

\* \* \* \* \*

#### § 701.13 [Amended]

3. Section 701.13 is amended in paragraph (a)(2) by revising "§ 701.12(e)" to read "§ 701.12(g)".

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## DEPARTMENT OF TRANSPORTATION

### Federal Aviation Administration

#### 14 CFR Part 39

[Docket No. 95-NM-120-AD]

#### **Airworthiness Directives; McDonnell Douglas Model DC-10 Series Airplanes and Model MD-11F (Freighter) Airplanes**

**AGENCY:** Federal Aviation Administration, DOT.

**ACTION:** Notice of proposed rulemaking (NPRM).

**SUMMARY:** This document proposes the adoption of a new airworthiness directive (AD) that is applicable to all Model DC-10 series airplanes and MD-11F airplanes. Among other things, this proposal would require repetitive leak checks of the lavatory drain system and repair, if necessary; would provide for