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American Institute of Certified Public Accountants. Credit Unions Committee

Audit and Accounting Guide

AUDITS of CREDIT UNIONS

With Conforming Changes As of May 1, 1992

AICPA
American Institute of Certified Public Accountants

Audit and Accounting Guide

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With Conforming Changes As of May 1, 1992

This edition of the audit and accounting guide *Audits of Credit Unions* has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative pronouncements since the guide was originally issued. The changes made are identified in a schedule in Appendix F of the guide. The changes do *not* include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

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NOTICE TO READERS

This audit and accounting guide presents recommendations of the AICPA Credit Unions Committee on the application of generally accepted auditing standards to audits of financial statements of credit unions. This guide also presents the committee's recommendations on and descriptions of financial accounting and reporting principles and practices for credit unions. The AICPA Accounting Standards Executive Committee and members of the AICPA Auditing Standards Board have found this guide to be consistent with existing standards and principles covered by Rules 202 and 203 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from this guide.

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Preface

This audit and accounting guide has been prepared to assist the independent CPA in auditing and reporting on financial statements of credit unions. Additionally, it should help the supervisory committee, management, and directors of credit unions, as well as other interested persons, understand the nature and scope of audits of credit unions by independent CPAs.

This guide emphasizes those aspects of accounting and auditing unique to the credit union industry, reflecting the presumption that the CPA understands accounting and auditing aspects that are common to business enterprises in general. The guide presents typical audit situations in credit unions, including the CPA's consideration of internal control structure policies and procedures; however, the discussions do not necessarily cover all situations that a CPA might encounter in a specific credit union. Also, auditing procedures prescribed by the National Credit Union Administration may be more detailed than those prescribed by generally accepted auditing standards.

When this guide was originally drafted, references to AICPA Statements on Auditing Standards and to the authoritative accounting pronouncements of the Financial Accounting Standards Board (FASB) and its predecessor organizations, including the Accounting Principles Board (APB) and the Committee on Accounting Procedure, are intended to include the specific pronouncements as well as all subsequent amendments and interpretations through January 31, 1986. The AICPA staff has added references to pronouncements issued after that date and revised references to pronouncements superseded or amended after that date.

The provisions of this guide are effective for audits of financial statements for years beginning after December 15, 1986. Accounting adjustments that may be required to conform with the accounting and reporting procedures set forth in this guide should be retroactively applied to prior period financial statements.

Credit Unions Committee

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Chapter 1

Organization and Supervision

The U.S. Credit Union Movement

1.01 Although the credit union movement began in the United States as long ago as 1909, the number of credit unions has grown rapidly and continuously since the enactment of the Federal Credit Union Act in 1934. Similar legislation has been enacted by the states.

1.02 Credit unions are cooperatives owned and directed by and dedicated to serving members who are united by a common bond of professional, geographical, or social identity. Credit unions are exempt from federal income taxes, and most are exempt from state and local income taxes. As traditional savings and lending institutions, they have long played an important role in individual savings and consumer installment loans. As a result of recent legislative and regulatory changes, credit unions may now offer expanded services—for example, new deposit instruments, share drafts, long-term real estate loans, credit cards, and electronic-based funds systems, such as automated teller machines.

Organization and Structure

1.03 Volunteers make many decisions in most credit unions. The law requires that the board of directors and a supervisory committee of a credit union be elected or appointed from its membership. In addition, a credit committee may be appointed or elected to oversee the lending transactions. The supervisory committee—similar to an audit committee—plays a major role in monitoring the credit union's affairs.

1.04 The supervisory committee is charged by law with the responsibility of supervising the internal control structure and the audit activities of the credit union. Because the committee may engage a CPA to audit and report on the credit union's financial statements, the CPA performs these services usually at the request of the supervisory committee. (See paragraph 2.30 for a discussion of the supervisory committee.)

1.05 A number of trade organizations are involved in the regulatory and legislative affairs of the credit union industry. These organizations include the Credit Union National Association (CUNA), the National Association of Federal Credit Unions (NAFCU), and various state leagues. These groups may provide such services as supplies, marketing, insurance, fund transfers, and investment instruments through their affiliates.

Government Supervision

1.06 A credit union operates under a federal or state charter and is therefore subject to government supervision and regulation, including periodic examinations by supervisory agency examiners. A federally chartered credit union is supervised by the National Credit Union Administration (NCUA), which is responsible for administering the National Credit Union Share Insurance Fund (NCUSIF). The NCUSIF provides share insurance to all federal credit unions and federally insured, state-chartered credit unions and insures each deposit up to a specified amount. In return for this protection to its members, each credit union pays an assessment based on its total savings accounts.

1.07 A state-chartered credit union is regulated by the supervisory agency of the chartering state. They have the option of obtaining NCUSIF share insurance coverage or securing insurance from other sources.

1.08 The Depository Institution Deregulation and Monetary Control Act of 1980 significantly changed monetary reserve requirements (Regulation D) for financial institutions, calling for insured depository institutions, including credit unions, to maintain reserve balances within the Federal Reserve System.

National Credit Union Administration

1.09 Over 60 percent of all credit unions are federally chartered by the NCUA, which issues regulations for both federal credit unions and federally insured, state-chartered credit unions. States adopt their own regulations for state-chartered credit unions. Several NCUA publications provide useful background information to auditors who serve credit unions:

- *Accounting Manual for Federal Credit Unions*
- *Credit Manual for Federal Credit Unions*
- *Supervisory Committee Manual for Federal Credit Unions*
- *National Credit Union Administration Rules and Regulations*
- *The Federal Credit Union Act*
- *Federal Credit Union Bylaws*
- *Annual Report of the National Credit Union Administration*

Chapter 2

Auditing Considerations

Auditing in a Credit Union Environment

2.01 As used in this guide, the term *audit* refers to an audit made by a CPA in accordance with generally accepted auditing standards for the purpose of expressing an opinion on a credit union's financial statements (unless the context clearly indicates that the reference is to an internal audit). The term *examination* generally refers to an examination made by a supervisory authority. An important purpose of a supervisory examination is the protection of credit union members, and, accordingly, the supervisory agency examiner emphasizes the quality of assets, liquidity, adequacy of retained earnings, management ability, future earnings ability, and compliance with applicable laws and regulations. Supervisory examinations also emphasize the review and classification of loans. Although an audit also covers most of those areas, the auditor's scope generally is broader, enabling the auditor to state an opinion on the financial statements as a whole.

Planning the Audit

2.02 In planning the audit of financial statements of a credit union, the auditor usually performs a preliminary review of financial data and reviews internal audit reports, reports of examinations by supervisory agencies, and related correspondence. Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision,* contains general guidance on planning an audit. Also, SAS No. 47, *Audit Risk and Materiality in Conducting an Audit,* discusses how the auditor's preliminary judgments about materiality levels and considerations of audit risk factors affect planning.

2.03 Examples of the types of information that may be assembled when planning the audit, and the arrangements to be considered, include the following:

1. General
   - Engagement letter
   - Location of offices
   - Office hours of employees
   - Hours open to the public for business
   - Audit personnel requirements—interim and year-end
   - Letters of accreditation for audit personnel
   - Data processing equipment and systems
   - Daily closeout procedures
2. Internal Control Structure
   - Policy and procedure manuals and organization charts
   - Report samples
   - Client-prepared descriptions of the accounting system
   - Samples of forms used to initiate and record transactions
   - System flowcharts
3. Cash and Consigned Items
   - Number of tellers
   - Number of bank accounts

Approximate volume of receipts and disbursements (number of transactions)
Number and location of cash funds (other than teller funds)
Location of consigned items (such as money orders and travelers' checks)

4. Investment Securities
   Location of securities
   Volume of transactions
   Documentation of fair market value
5. Loans
   Number of accounts by major classes of loans
   Existence of loans and participations purchased or sold
   Location of detail and control accounts
   Location of all collateral and supporting documentation
   Interest payment dates
   Interest accrual policies
6. Savings Accounts
   Types of accounts offered
   Number of accounts
   Location of detail and control accounts
   Interest payment dates
   Existence of accounts that request "no correspondence"
   Procedures for dormant accounts
   Interest accrual process
7. Other Items
   Access to minutes
   Subsidiaries of the credit union (such as service corporations)
   Major accounting policies
   Related parties (including sponsor organizations)
   Types of borrowed funds (including Central Liquidity Fund (CLF) advances, bank loans, collateralized borrowing agreements, or other borrowings)

Timing of the Audit

2.04 The nature, timing, and extent of the audit procedures to be performed and the resulting reports to be issued are determined by the auditor and are based on the type of engagement, as established by the supervisory committee. Before starting the audit, the auditor should meet with the supervisory committee to establish and agree on the type of engagement to be performed. Many auditors specify in the engagement letter the services to be performed.

2.05 Based on several factors, the auditor may determine that a significant amount of the audit can be performed at an interim date. [1] In such cases, SAS No. 45, *Omnibus Statement on Auditing Standards,* "Substantive Tests Prior to the Balance-Sheet Date," provides guidance on extending audit conclusions to the balance-sheet date and states "substantive tests should be

[1] SAS No. 45, *Omnibus Statement on Auditing Standards,* "Substantive Tests Prior to the Balance-Sheet Date," identifies factors to be considered in the timing of audit procedures.

designed to cover the remaining period in such a way that the assurance from those tests and the substantive tests applied to the details of the balance as of an interim date, and any audit assurance provided from the assessed level of control risk, achieve the audit objectives at the balance-sheet date."

2.06 Most credit unions end their fiscal years on December 31, but the date of the financial statements being audited may not coincide with the fiscal year-end of the credit union. Timing of the audit should be agreed upon with the supervisory committee.

Risks in the Credit Union Industry

2.07 To determine the scope of audit procedures to be performed, the auditor should be aware of certain factors peculiar to the credit union industry.

2.08 There are economic risks. As supply and demand for credit fluctuates, the effect on interest rates entails risks for credit unions. As money becomes tighter and interest rates rise, various risks become more pronounced.

2.09 The *credit risk* is significant in most credit unions. The following factors may cause loans to develop credit risk problems:

- Improper credit extension procedures
- Changes in the national economy or in the economy of the credit union's specific geographical area
- Changes in the status of a particular industry (and/or the sponsoring organization)
- Undue loan concentration
- Deterioration in the credit worthiness of the borrowers

2.10 Loan quality is the principal factor in consideration of the adequacy of the allowance for loan losses.

2.11 Credit unions are exposed to *interest rate risk* when their assets are subject to legal interest rate ceilings or are invested in intermediate- or long-term fixed-rate loans or securities and when these assets are funded through interest-sensitive short-term liabilities. If management misjudges the movement of interest rates and the rates rise substantially, the credit union must refinance short-term borrowing at higher rates, which may result in lower overall profit margins and, possibly, an overall loss.

2.12 Credit unions are exposed to *liquidity risk* when they invest disproportionately in long-term securities, which generally decrease in market value when interest rates rise. If a credit union is forced to sell these investments to generate cash, large losses may be incurred on the transactions. If the credit union's liquidity is not sufficient to meet prospective needs and there is evidence that the credit union may have to dispose of certain assets to attain liquidity, the auditor should consider the propriety of the accounting basis for any assets that the credit union may sell. Serious illiquidity is a condition that may indicate there could be substantial doubt about the credit union's ability to continue in existence for a reasonable period of time. Such conditions should be evaluated in accordance with SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern.*

Audit Objectives

2.13 SAS No. 31, *Evidential Matter,* provides the auditor with guidance on the third standard of fieldwork, stating—

> In obtaining evidential matter in support of financial statement assertions, the auditor develops specific audit objectives in the light of those assertions. In developing the audit objectives of a particular engagement, the auditor should consider the specific circumstances of the entity, including the nature of its economic activity and the accounting practices unique to its industry.

These assertions can be classified into five broad categories:

- *Existence or occurrence.* Do assets or liabilities of the entity exist at a given date, and have recorded transactions occurred during the given period?
- *Completeness.* Are all transactions and accounts that should be presented in the financial statements included?
- *Rights and obligations.* Do all assets belong to the entity, and are all liabilities obligations of the entity at a given date?
- *Valuation or allocation.* Have all asset, liability, revenue, and expense components been included in the financial statements at their appropriate amounts?
- *Presentation and disclosure.* Are components of the financial statements properly classified, described, and disclosed?

2.14 Specific audit objectives that are unique to the credit union industry and that might be developed to evaluate the evidential matter supporting management's assertions in the financial statements are discussed in later chapters.

Internal Control Structure

2.15 The second standard of fieldwork states—

> A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit,* provides guidance on the independent auditor's consideration of an entity's internal control structure in an audit of financial statements in accordance with generally accepted auditing standards. It describes the elements of an internal control structure and explains how an auditor should consider the internal control structure in planning and performing an audit.

2.16 An entity's internal control structure consists of three elements: the control environment, the accounting system, and control procedures. In all audits, the auditor should obtain a sufficient understanding of each of the three elements to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation. After obtaining this understanding, the auditor assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. The auditor may assess control risk at the maximum level (the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control structure) because he believes policies and procedures are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient. Alternatively, the auditor may obtain evidential matter about the effectiveness of both the design and operation of a policy or procedure that supports a lower assessed level of control risk. Such evidential matter may be obtained from tests of controls planned and performed concurrently with obtaining the understanding or from procedures performed to obtain the understanding that were not specifically planned as tests of controls.

2.17 After obtaining the understanding and assessing control risk, the auditor may desire to seek a further reduction in the assessed level of control risk for certain assertions. In such cases, the auditor considers whether evidential matter sufficient to support a further reduction is likely to be available and whether performing additional tests of controls to obtain such evidential matter would be efficient. The auditor uses the knowledge provided by the understanding of the internal control structure and the assessed level of control risk in determining the nature, timing, and extent of substantive tests for financial statement assertions.

2.18 Internal control structure policies and procedures over cash, consigned items, loans to members, investments owned, savings accounts, and the handling of transactions related to those items are especially important in credit unions. For example, cash-handling functions should be segregated, to the extent practicable, from related record-keeping responsibilities. Adequate controls should be established over savings accounts, including inactive accounts; lending procedures, including loan approvals; document control; and loan disbursements.

2.19 The independent auditor may become aware of material weaknesses in the internal control structure during the performance of the audit. SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit,* provides guidance on identifying and reporting conditions that relate to an entity's internal control structure observed during an audit of financial statements. SAS No. 60 further states that it is contemplated that the communication would generally be to the audit committee or to individuals with a level of authority and responsibility equivalent to an audit committee in organizations that do not have one, such as the board of directors, the board of trustees, an owner in an owner-managed enterprise, or others who may have engaged the auditor. In a credit union, the supervisory committee normally receives this report.

2.20 The NCUA and some state regulators may require that they be provided with a report of recommendations for procedural changes that would strengthen existing internal control structure policies and procedures.

2.21 The auditor should be familiar with the section in the NCUA's *Accounting Manual for Federal Credit Unions* titled "Internal Controls," which discusses administrative and accounting controls. It also identifies, in chart form, positions in federal credit unions that may not be held concurrently.

2.22 Appendix B of this audit guide summarizes control procedures and conditions the auditor may wish to consider in his or her consideration of a credit union's internal control structure in connection with either an audit or a special engagement.

Internal Audit Function

2.23 SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* provides auditors with guidance on considering the work of internal auditors and on using internal auditors to provide direct assistance to the auditor in an audit performed in accordance with generally accepted auditing standards.

Application of Audit Sampling

2.24 Several audit procedures used in credit unions may entail audit sampling. Such procedures may include tests of controls as well as substantive tests, such as requests of confirmation for the savings and the loan accounts of the members.

2.25 SAS No. 39, *Audit Sampling,* provides guidance for planning, performing, and evaluating both statistical and nonstatistical audit samples. The statement also includes discussions intended to enhance professional judgment in assessing sampling risk, planning samples, sample selection, and performance and evaluation. [2]

Auditing and Electronic Data Processing (EDP) Systems

2.26 Many credit unions use some form of an EDP system, which may be operated solely by the credit union, shared with others, or provided by an independent organization for a fee. Typical applications of EDP systems are loans, savings, payroll, and general ledger. In addition, some credit unions may be involved in such activities as direct deposit, electronic funds transfer, automated clearing house, preauthorized allotment receipts, automated teller machines, and telephone bill payer operations.

2.27 The use of EDP equipment does not affect the objectives of the audit; however, the organizational and control procedures used may differ from those used in manual or mechanical data processing, and audit procedures applied to accounting records maintained on EDP equipment may vary from those applied to records maintained manually or on mechanical equipment. This guide does not discuss the effects of EDP on an audit.

2.28 Guidance in auditing records in which EDP processing is significant is contained in the following documents:

- SAS No. 44,* *Special-Purpose Reports on Internal Accounting Control at Service Organizations*
- SAS No. 48, *The Effects of Computer Processing on the Audit of Financial Statements*
- AICPA Audit and Accounting Guide, *Computer Assisted Audit Techniques*
- AICPA Computer Services Guidelines, *Audit Considerations in Electronic Funds Transfer Systems*
- AICPA Computer Services Guidelines, *Audit and Control Considerations in a Minicomputer or Small Business Computer Environment*

The auditor may also consult the Federal Financial Institutions Examinations Council's *EDP Examination Handbook,* which includes a section titled "Internal and External EDP Audit."

Client Representations

2.29 SAS No. 19, *Client Representations,* requires the auditor to obtain certain written representations from management as part of an audit and provides guidance concerning these representations. The specific written representations to be obtained depend on the circumstances of the engagement

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[2] An audit guide, *Audit Sampling,* was issued by the AICPA in 1983. This guide provides guidance to assist auditors using either statistical or nonstatistical audit sampling in applying SAS No. 39.

* SAS No. 70, *Reports on the Processing of Transactions by Service Organizations,* supersedes SAS No. 44 and is effective for service auditors' reports dated after March 31, 1993.

and on the nature and basis of presentation of the financial statements. Paragraph 4 of SAS No. 19 lists matters ordinarily included in management's representation letter. Certain other representations related to credit union operations are normally obtained from credit union clients. These other items include, but are not necessarily limited to, representations that—

- All contingent assets and liabilities, including loans charged off, have been adequately disclosed in the financial statements, where appropriate.
- Adequate provision has been made for any losses, costs, or expenses that may be incurred on securities, loans, or leases as of the statement of financial condition date.
- Liabilities are adequate for interest on deposits and borrowed funds.
- Permanent declines in value of securities and other investments have been properly reported in the financial statements.
- Commitments to purchase or sell securities have been adequately disclosed in the financial statements, where appropriate.

The Supervisory Committee

2.30 Section 115 of the Federal Credit Union Act states—

> The supervisory committee shall make or cause to be made an annual audit and shall submit a report of that audit to the board of directors and a summary of the report to the members at the next annual meeting of the credit union; shall make or cause to be made such supplemental audits as it deems necessary or as may be ordered by the Board, and submit reports of the supplementary audits to the board of directors.

Similar requirements may exist for state-chartered credit unions.

Compliance With Regulations

2.31 SAS No. 54, *Illegal Acts by Clients,* prescribes the nature and extent of the consideration an auditor should give to the possibility of illegal acts by a client in an audit of financial statements in accordance with generally accepted auditing standards. The ultimate responsibility for compliance with applicable laws and regulations rests with management. The auditor's responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for errors and irregularities described in SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities.* SAS No. 53 states that the auditor should assess the risk that errors and irregularities may cause the financial statements to contain a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements.

[2.32—2.38] [Deleted—Section was originally drafted on the basis of the concepts described in SAS No. 17, *Illegal Acts by Clients.* SAS No. 17 was superseded by SAS No. 54. Paragraph 2.31 reflects the changes necessary to update this section to conform to SAS Nos. 53 and 54.]

Charter, Bylaws, and Minutes

2.39 The NCUA issues charters for federally chartered credit unions and prescribes the form of bylaws of such credit unions. For state-chartered credit unions, the appropriate state regulatory authority establishes the form of the charter and bylaws.

2.40 The auditor should review the charter and bylaws. The audit program may include procedures to determine compliance with charter and bylaw provisions that may have a material effect on the financial statements.

2.41 The auditor should read the minutes of the meetings of the board of directors, credit committees and/or loan officers, and other committees, noting items that have an effect on the internal control structure and the financial affairs of the credit union. The auditor should observe that the minutes have been approved and that all material transactions discussed therein have been executed in accordance with the minutes.

2.42 The board of directors' minutes generally include approvals of such matters as loans charged off, transfers to and from retained earnings, purchases and sales of investments, major purchases and sales of property and equipment, borrowing arrangements, authorization and designation of terms of certain types of savings accounts, and rates on savings accounts.

2.43 Important transactions or matters requiring action by the directors or the members that are not covered in the minutes should be called to management's attention so that necessary approvals may be secured.

Auditors' Reports

2.44 The types of reports to be issued are based on the scope of services required by the credit union. The auditor should establish an understanding with the credit union, preferably in writing, regarding the services to be performed. The following are some typical services the auditor may be engaged to perform:

- Reporting on the financial statements of the credit union
- Assisting the supervisory committee in fulfilling its responsibilities by performing agreed-upon procedures
- Reporting on internal accounting control

2.45 The auditor's standard report on the financial statements of a credit union is the same as that used for other business enterprises.

2.46 An auditor may be involved with information other than the financial statements. SAS No. 52, *Omnibus Statement on Auditing Standards,* "Required Supplementary Information," states—

> The objective of an audit of financial statements in accordance with generally accepted auditing standards is the expression of an opinion on such statements. The auditor has no responsibility to audit information outside the basic financial statements in accordance with generally accepted auditing standards. However, the auditor does have certain responsibilities with respect to information outside the financial statements. The nature of the auditor's responsibility varies with the nature of both the information and the document containing the financial statements. The auditor's responsibility for other information not required by the FASB or GASB but included in certain annual reports—which are client-prepared documents—is specified in SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards,* vol. 1, AU sec. 550). The auditor's responsibility for information outside the basic financial statements in documents that the auditor submits to the client or to others is specified in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards,* vol. 1, AU sec. 551). The auditor's responsibility for supplementary information required by the FASB or GASB (called *required supplementary information*) is discussed in [SAS No. 52].

2.47 SAS No. 42, *Reporting on Condensed Financial Statements and Selected Financial Data,* provides guidance on reporting in a client-prepared document on condensed financial statements and selected financial data that are derived from audited financial data.

2.48 An auditor may be engaged to perform only specified procedures, such as confirmation of members' accounts. If so, the auditor should issue a special report in conformity with SAS No. 35, *Special Reports—Applying Agreed-upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement,* which requires that distribution of the report be restricted.

2.49 A credit union may request an auditor to report on a study and evaluation of the credit union's system of internal accounting control, either in conjunction with an audit or as a special study. SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* and SAS No. 30, *Reporting on Internal Accounting Control,* provides guidance for such reports.

Regulatory Accounting Practices

2.50 Regulatory accounting practices may differ from generally accepted accounting principles. Some of the more common variances are as follows:

- Accounting records maintained on a modified cash basis
- Regulatory requirements to classify savings (shares) as equity
- Acceptability of settlement date accounting for investment securities
- Dividends on savings accounts not reported as expense
- Provision for loan losses not reported as expense

2.51 If variances from generally accepted accounting principles are material in amount, the auditor should qualify his opinion or give an adverse opinion. The auditor's report should refer to the variance specifically and should give a clear explanation of the nature of the modifications and the effect of the variance, if determinable, on the financial condition, results of operations, and cash flows. The auditor should refer to sections 544.02 and .04 of SAS No. 1, which provide guidance on reporting on regulated companies; SAS No. 62, *Special Reports;* and paragraphs 49 through 66 of SAS No. 58, which deal with reporting if there is a departure from a generally accepted accounting principle or a promulgated accounting principle.

Communications Between Independent Auditors and Examiners

2.52 The independent auditor should review reports of significant examinations and related communications between examiners and the financial institution and, when appropriate, make inquiries of the examiners. The independent auditor should—

- Request that management provide access to all reports of examinations and related correspondence.
- Review reports of significant examinations and related correspondence between examiners and the financial institution during the period under audit through the date of the independent auditor's report.
- Communicate with the examiners, with the prior approval of the financial institution, when their examination of the financial institution is in process or a report on an examination has not been received by the financial institution.

2.53 A refusal by management to allow the independent auditor to review communications from, or to communicate with, the examiner would ordinarily be a limitation on the scope of the audit sufficient to preclude an opinion (see paragraphs 40 through 44 of SAS No. 58). A refusal by the examiner to communicate with the auditor may be a limitation on the scope of the audit sufficient to preclude an unqualified opinion, depending on the auditor's assessment of other relevant facts and circumstances.

2.54 In addition, the independent auditor should consider attending, as an observer, with the prior approval of the financial institution, the exit conference between the examiner and the financial institution's board of directors (or an appropriate board committee) or its executive officers or both. Also, if the examiners request permission to attend the meeting between the independent auditor and management or the financial institution's board of directors (or an appropriate board committee) or both to review the report on the audit of the financial statements, and management concurs, the independent auditor should endeavor to be responsive to that request.

Chapter 3

Cash

3.01 Cash generally includes cash on deposit in other depository institutions and cash on hand.

3.02 Cash on deposit includes balances on deposit in financial institutions and deposits in transit. These amounts may or may not be subject to withdrawal by check and may or may not be interest bearing.

3.03 Cash on hand consists primarily of a change fund and petty cash funds. A credit union's change fund is a supply of currency and coins used to cash checks, make savings withdrawals and loan disbursements, cash savings bonds, and make change. The fund often comprises the tellers' working funds, a reserve fund kept in the vault, or vault funds in transit. It may also include a currency supply for automated teller machines. Each teller should be individually responsible for the funds in his or her possession, but supervisory personnel should control the vault reserve fund.

Financial Statement Presentation

3.04 It is generally unnecessary to distinguish among the various elements included within the "cash" caption; therefore, the financial statement caption for cash includes deposits in financial institutions, deposits in transit, cash items, or cash on hand. However, cash not subject to immediate withdrawal or restricted in some other manner should be properly disclosed and may need to be segregated in the statement of financial condition.

Auditing

Objectives

3.05 The significant audit objectives for cash are to consider whether the balances are fairly stated in conformity with generally accepted accounting principles and whether cash items held will clear in the normal course of business.

Procedures

3.06 Cash is a significant item to a credit union because of the large volume of cash receipt and disbursement transactions. Most cash receipts result from savings deposits and payments on loans. Cash disbursements consist primarily of savings withdrawals, loan disbursements, and operating expenses. The nature of these transactions makes the teller the originator of a significant portion of the daily cash accounting entries. Thus, the principal documents tested by the auditor are cash received vouchers, checks used for disbursement purposes, and journal vouchers affecting cash. Typical audit procedures include the following:

- Count cash
- Control undeposited receipts
- Test bank reconciliations
- Test interbank transfers
- Review cash over and short summaries
- Test tellers' proof sheets
- Test control of mail receipts
- Test propriety of authorized accounts and signatures

- Reconcile subsidiary ledgers to general ledger
- Confirm account balances

3.07 In addition, the auditor should be alert to the presence of consigned items, a category that includes traveler's checks, money orders, savings bonds, and similar items. Positive confirmation from the consignors should be considered. The internal control structure policies and procedures over supplies of consigned items may be considered during the audit to determine the nature and extent of substantive testing.

3.08 Internal control structure considerations for cash are listed in Appendix B of this guide.

Chapter 4

Investment Securities

4.01 The management of credit union funds allows alternatives in the choice of assets, with the investment objective being an optimum balance of credit quality, liquidity, and income. This objective is attained through the investment portfolio, which typically is the credit union's second most significant asset after loans (see the discussion of loans in chapter 5).

4.02 Liquidity of the investment securities is an important consideration in the credit union's portfolio, for liquidity is required to meet normal, anticipated withdrawals of deposits, to provide a margin of safety for unforeseeable withdrawals, and to meet the members' credit needs. Furthermore, securities may be required to be pledged to guarantee the collectibility of certain government deposits or as collateral for borrowings.

4.03 Federal and state regulations may affect credit union investment decisions, particularly those restricting the types of investments available to credit unions, which are generally limited to the following:

- Investments in corporate central credit unions
- U.S. Treasury obligations, such as Treasury bills, notes, and bonds
- Obligations and instruments of any agency of the United States
- Mortgage-backed securities issued or fully guaranteed by an agency of the United States
- Common trust or mutual investment funds approved by appropriate regulatory authorities
- Investment in the Central Liquidity Facility
- Investment deposits in any federally insured financial institution
- Investments in or loans to other credit unions
- Other investments, as outlined in section 107 of *The Federal Credit Union Act* or similar state statutes

4.04 The following are currently *unauthorized* (prohibited) investment activities for a federal credit union:

- Standby commitments to purchase or sell a security
- Futures contracts
- Adjusted trading or short sales
- Yield-maintenance contracts
- Pair-off transactions (matching or netting of commitments to purchase and sell securities via cash forward agreements)
- Common stocks
- Corporate debt obligations
- Equity participation in commercial real estate projects

4.05 The auditor should be aware of any limitations imposed on state-chartered credit unions.

Accounting

4.06 Some credit unions traditionally record the purchase and sale of investment securities and the effect of transactions and valuation adjustments on the settlement date. Others record such transactions on the trade date. Trade date accounting is the proper method and settlement date accounting, which is the prevalent practice in credit unions (see "Regulatory Accounting

Practices" in paragraphs 2.50 and 2.51), is acceptable only if the reported amounts would not be materially different.

4.07 If investment securities are held to maturity, they will generally be redeemed at face value; therefore, they are carried at amortized cost. If credit unions have the ability and intent to hold these securities on a long-term basis, credit unions do not customarily provide for unrealized declines in their value resulting from interest rate fluctuations.

4.08 However, adjustments would be required to the carrying amounts of certain securities in conformity with FASB Statement No. 12, *Accounting for Certain Marketable Securities.* In addition, because it may be necessary to dispose of securities in the foreseeable future to meet the credit union's investment objectives or other operational needs, an allowance for estimated losses should be established to provide for a decline in the securities' value if (a) credit union management intends to dispose of a part of its investment securities portfolio in the foreseeable future or (b) the credit union is unable to hold a portion of its investment portfolio to maturity.

4.09 An allowance also should be provided if there is a market decline that is attributable to specific adverse conditions for a particular security unless persuasive evidence exists to support the carrying amount.

4.10 The related provisions for these allowances for estimated losses should be charged to earnings and classified in the income statement with securities gains and losses. If subsequent events prove that the conditions precipitating the origination of the allowance were only temporary in nature, the allowance should be reduced or eliminated. In no event should securities be valued in excess of cost.

Premiums and Discounts

4.11 Investment securities are generally acquired at a premium, a price in excess of face value, or at a discount, a price less than face value. A premium paid for a bond at the time of original issuance or at some time thereafter represents a downward adjustment of the stated rate of interest to reflect the market yield at the time of purchase. Conversely, a bond discount represents an upward adjustment of the stated rate of interest to the market yield at the time of purchase. The carrying amount of the bond during the holding period is systematically adjusted to the amount anticipated to be realized at the maturity date. Amortization of premium or accretion of discount results in a reflection in the income statement of a yield that approximates the market yield at purchase date.

4.12 The entry to record the amortization of premium requires a debit to interest income with a corresponding credit to the investment asset or accumulated amortization account, which is netted against the asset account on the statement of financial condition. The reverse entry is used to record discount accretion. Accretion of bond discount and amortization of bond premium are based on the assumption that the face amount of the investment will be realized at maturity or at a call date.

4.13 The period of amortization or accretion is from the purchase date to the maturity date, except for securities purchased at a premium carrying an earlier call date at a price higher than par. The premium for these securities should be amortized to the maturity date or to an earlier call date. Premiums or discounts related to such securities as Government National Mortgage

Association (GNMA) modified pass-through certificates should be systematically amortized or accreted over the estimated average life of the contract.[3]

4.14 The two prevalent methods of amortizing premium or accreting discount are the interest method as defined in APB Opinion No. 21, *Interest on Receivables and Payables*, and the straight-line method.

4.15 The interest method of amortizing or accreting premium or discount recognizes an amount in earnings each month that produces a constant yield equal to the market yield at the date of purchase. When this method is used, the total amount of accreted discount added to the book value of the security by the end of each month increases each month; therefore, the amount of accretion credited to earnings also increases each month so that a level yield is reported. Conversely, the total amount of premium amortization deducted from the book value of the security by the end of each month increases each month; therefore, the amount of amortization charged to earnings increases each month so that a level yield is reported.

4.16 Straight-line accretion of discount or amortization of premium results in equal periodic adjustments to earnings from the time of purchase to the maturity date or earlier call date. The method has the advantages of being simple to compute and of affecting earnings each month by the same amount. However, the book yield on the security decreases or increases each month, because the book value of the security is increased or decreased monthly by the amount of accretion or amortization reflected in monthly earnings.

4.17 The accretion of discount or the amortization of premium should be recorded in a manner that produces a constant rate of return on the basis of adjusted book value (interest method). However, straight-line or other methods of amortization or accretion may be used if the results obtained do not vary materially from those that would be obtained by the interest method.

Securities Gains and Losses

4.18 A credit union realizes gains and losses as the result of sales, early redemptions, and exchanges of investment securities. The recognition of discount gains and premium losses at maturity is eliminated for financial reporting purposes if bond premiums are amortized and discounts accreted. On securities sold before maturity, the gains and losses, even after adjustment for accreted discount and amortized premium, can be significant.

4.19 Previously unrecognized securities gains and losses should be recognized on the completed transaction basis; that is, the gains and losses should be recognized on the trade date for financial reporting purposes.

4.20 The amounts invested in investment portfolios in many credit unions may fluctuate with changes in savings account levels and loan demand. The fluctuation may result in substantial buying and selling of investments. When funds are in ample supply, securities prices tend to be high and yields comparatively low. At those times many credit unions buy securities in order to make productive use of available cash. Conversely, when funds are scarce, securities prices tend to be low. The demand for funds may cause credit unions to sell securities at substantial losses to satisfy loan demand and, on occasion, to meet savings account withdrawals. The transactions may produce substantial securities gains or losses.

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[3] See FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.*

4.21 If there is substantial turnover in the investment portfolio, management's intention and experience determine whether a trading function is occurring and the appropriate classification and valuation method to be used.

Troubled Debt Restructuring

4.22 Accounting and reporting requirements for securities that have been involved in troubled debt restructurings (including instances in which the substitution of debtors is primarily a matter of form) are set forth in FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings.*

Financial Statement Presentation

4.23 Disclosure of the market value of investment securities, either in the statement of financial condition or in the notes to the financial statements, helps a reader of the credit union's financial statements evaluate the potential earning power of those investments, because the potential earning power is governed by prevailing market interest rates applied to the estimated market value and not by the book value of the credit union's invested assets. Market value should be disclosed.

4.24 Securities that are pledged for borrowing or other purposes should also be disclosed in the financial statements.

4.25 A credit union may loan cash to a member bank of the Federal Reserve System. Such loans are commonly referred to as *federal funds.* Ordinarily, such loans are for one day only, with the lending credit union regaining its funds on the business day following the loan. If material, the amount of such loans should be classified separately in the financial statements.

4.26 A credit union may invest in short-term repurchase agreements, commonly referred to as *repos.* These transactions represent purchases of securities on a short-term basis under agreements whose terms provide that the sellers will repurchase the securities within a short period of time, usually a few days. If material, these investments should be classified separately in the financial statements.

4.27 A credit union may also borrow under fixed coupon-repurchase agreements, commonly referred to as *reverse repos.* In substance, these arrangements generally represent borrowings collateralized by the related securities. AICPA SOP 85-2, *Accounting for Dollar Repurchase-Dollar Reverse Repurchase Agreements by Sellers-Borrowers,* provides accounting guidance relating to dollar reverse repurchase agreements. When funds are borrowed under these arrangements, a liability should be established for the amount of the proceeds. The investment security account should not be relieved of the collateral securities. Interest on reverse repos should be reported as an expense and not shown net of interest income.

4.28 Losses not previously recognized and gains from securities transactions should be recorded in the statement of income for the period in which securities are sold or otherwise disposed of.

Auditing

Objectives

4.29 The significant objectives of tests of a credit union's investment securities are to obtain reasonable assurance that—

- All required disclosures have been made.
- The physical securities are on hand or held in custody for safekeeping by others for the account of the credit union.
- Interest and dividend income and securities gains and losses have been recorded properly.
- Investments and the related income, gains, and losses are fairly presented in conformity with generally accepted accounting principles in the financial statements, including disclosure of amounts pledged and market value.
- Investments have not suffered a permanent reduction in recoverable value, and allowances for losses have been provided where necessary.
- Investments comply with federal and state regulations.

4.30 The auditor should be familiar with an auditing interpretation titled *Evidential Matter for the Carrying Amount of Marketable Securities* (AICPA, *Professional Standards*, vol. 1, AU section 9332, January 1975). This interpretation provides guidance on the evidence the auditor should obtain pertaining to classification and carrying value of marketable securities, including—

- Reasons for and evidence of the market decline when market value is below cost and evidence of whether the market decline is temporary or reflects more persistent conditions.
- Management's estimates of the outcome of future events.
- The credit union's financial position requirements for operating funds, and any contractual obligations, or other requirements that could affect the credit union's ability to hold the securities. For investments in bonds and other investments with fixed maturity amounts, market declines may be considered temporary unless the evidence indicates that such investments will be disposed of before they mature or that they may not be realizable.
- Management's representation regarding its intent in the credit union's representation letter. The auditor should read the minutes of the board of directors meetings and should inquire of the investment committee concerning management's intentions on disposing of the securities.

4.31 If securities that will be disposed of in the foreseeable future have a market value lower than their carrying amount, the auditor should obtain persuasive evidence that a recovery in the market value will occur before the securities' maturity or sale date, whichever is earlier, or within a one-year period from the statement of financial condition date. Generally, such evidence would be limited to substantial recovery subsequent to the year-end. If there is no evidence to support the carrying amount, and management has not established an allowance for the amount of the writedown to market value, the auditor should consider the need to modify the audit report for a departure from generally accepted accounting principles.

4.32 If securities not to be disposed of in the foreseeable future have a market value below cost, the auditor should consider the credit union's ability to recover the carrying value and should obtain persuasive evidence supporting the carrying amount. An allowance should be provided if there is a market decline that is attributable to specific adverse conditions for a particular security unless persuasive evidence exists to support the carrying amount. If the decline in market value is attributable to general market conditions, an allowance need not be established by management unless there is evidence that the carrying amount will not be recovered. If any required allowances are not established by management, the auditor should consider the need to modify the audit report for a departure from generally accepted accounting principles. The auditor should consider whether available information supports a judgment regarding eventual recovery or a contrary judgment that recovery will not occur. In such a situation, the auditor should consider the need to modify the audit report.

Procedures

4.33 Securities owned by the credit union at the audit date should be examined or confirmed directly with custodians of securities pledged by or held for the account of the credit union. In addition, the auditor should determine that investments are registered in the name of the credit union or held for safekeeping and that all unmatured coupons are intact and matured coupons have been clipped. In addition to the procedures mentioned, the auditor should examine documentation supporting open commitments to buy or sell securities, including repurchase agreements and reverse repurchase agreements, and request confirmation of such open commitments from parties through which the credit union buys or sells securities.[4]

4.34 The auditor should consider whether the testing of investments is properly coordinated with that of other negotiable items, such as cash, collateral held by the credit union as security for loans to members, and consigned items.

4.35 The board of directors is responsible for investment policies for credit union assets, with management authorized to make investment decisions in accordance with the board's policy. The auditor often tests controls relevant to this internal control structure policy by noting the following:

- Types of transactions
- Authorized employees transacting investments
- Authorized broker-dealers
- Periodic reporting to the board
- Safekeeping
- Surety bonds

4.36 Internal control structure considerations for investment securities are listed in Appendix B of this guide.

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[4] The *Report of the Special Task Force on Audits of Repurchase Securities Transactions*, issued by the AICPA in June 1985, provides additional guidance for auditing repurchase and reverse repurchase transactions.

Chapter 5

Loans

5.01 Loans are generally the largest asset of a credit union and may be classified as follows:

- Consumer loans
  - Collateralized loans (for example, automobiles, mobile homes, boats, household furnishings)
  - Unsecured loans
    - Signature loans
    - Lines of credit
  - Credit card loans
- Real estate mortgage loans
- Other loans
  - Loans collateralized by savings accounts
  - Agricultural loans
  - Business loans
  - Education loans

5.02 A credit union is chartered to originate loans to its *members*. Regulations further impose maximum limits to individual borrowers and prescribe restrictions for lending to insiders.

Consumer Loans

Collateralized Loans

5.03 A significant type of consumer (installment) loan in a credit union is one secured by personal property. The board of directors generally establishes lending policies that are administered by the credit committee or the loan officer and that cover the following areas:

- Maximum maturity of the loan
- Market value of security in excess of loan value
- Down payment requirements
- Hazard insurance with credit union named as loss payee
- Types of personal property accepted as collateral
- Lien recordation (accompanied by security agreement or financing statement)
- Financial condition of borrower
- Employment history of borrower

5.04 Pledged collateral may include the following items:

- Automobiles
- Mobile homes
- Household furnishings
- Assignment of land sales contracts
- Cash value of life insurance policies
- Marketable stocks and bonds
- Loans with cosigners or guarantors

5.05 The installment loan typically is structured for repayment in equal monthly payments, with interest computed at a contractual interest rate on the outstanding balance. A loan may be cosigned by a third-party or guaranteed by a third-party or by a government agency. Maturity of an installment loan generally depends on the nature of the loan and on the type of collateral.

5.06 Collateral records typically are maintained, either as part of the detail loan record or in separate files, indicating the current status of pledged collateral. When the loan has been paid or when collateral is withdrawn or substituted, the borrower acknowledges the release of the collateral by signing a collateral release, a copy of which is retained by the credit union.

Unsecured Loans

5.07 A common form of lending in credit unions is the unsecured signature loan, in which the borrower's obligation is evidenced only by an executed note. A credit union is responsible for implementing its own underwriting policies, which involve guidelines for investigating the following information about the borrower:

- Employment history
- Financial statement
- Credit report
- Loan application

5.08 In addition to the traditional unsecured signature loan, a credit union may grant a loan under a self-replenishing line of credit. The open-end, self-replenishing line-of-credit loan requires the borrower to complete the loan application and approval process only one time, except for periodic updating. The borrower may increase his outstanding loan balance up to a preapproved limit through the following:

- Check or cash disbursements
- Automated teller machine loan disbursements
- Loans to clear share overdrafts
- Loan draft disbursements

5.09 The line of credit is replenished by required minimum monthly payments. The line-of-credit agreement may be cancelled upon notice by either party, but this notice does not relieve a borrower from the obligation to repay funds borrowed under the agreement prior to its cancellation.

5.10 Another form of unsecured lending for credit unions is through the use of a credit card. The credit union may do the following:

- Issue the card, process the transactions, and assume the loan risk.
- Contract with a service company to issue the card in the credit union's name and allow the service company to process the transactions, but retain the loan risk.

5.11 After a credit card has been issued to a member, thereby establishing a line of credit, loan transactions are initiated by the member's purchase of goods or services from a participating merchant. The merchant submits the charge slips to his or her financial institution and receives credit for the amount of the transaction, less a negotiated discount. The charge slips are then processed and charged to the card holder's account. The card issuer receives a portion of the fee paid by the merchant to his financial institution for processing the charge slips.

5.12 The card holder normally receives a monthly statement. The entire account balance may be paid without interest, or the card holder may pay a portion of the balance and monthly interest computed on the outstanding balance in accordance with the credit union's policy.

5.13 Certain features of credit card operations warrant emphasis. Since the transaction is initiated through the use of an identification card, issued and unissued cards should be controlled to prevent fraudulent use. Theft of cards at the processing or delivery stage or after receipt by the card holder represents a significant risk of loss to a credit union. Merchants are generally required to obtain prepurchase authorization for purchases in excess of a specified amount. Credit unions monitor accounts with high balances, excessive activity, and delinquencies to lessen the possibility that inappropriate use of credit by the card holder will result in losses. In an effort to minimize losses resulting from fraudulent use of stolen cards or extension of credit to holders of terminated cards, credit unions regularly notify their agents of card numbers that are not to be honored.

5.14 Credit unions also offer other forms of revolving or open-end credit that are marketed under various programs and may include loan drafts related to their share draft plans.

Real Estate Mortgage Loans

5.15 Credit unions originate real estate loans to members *only*. These loans are generally secured by first or second mortgages and may extend for a period of up to forty years. In granting real estate loans, credit unions generally use forms developed jointly by the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). Repayment terms customarily require monthly payments of principal and interest. Certain mortgage loans may be priced on a variable rate or other repayment basis. The monthly payment often includes an amount to be held in escrow for the payment of real estate taxes and insurance.

5.16 In addition, credit unions may grant loans to finance construction. Construction loans generally are granted only after the borrower has arranged for long-term financing upon completion of construction (a takeout commitment). Although usually secured by real estate, construction loans generally entail more risk than real estate loans on improved property. Internal control structure policies and procedures over construction loans include documentation requirements for advances of funds and periodic on-site inspection of the property.

5.17 Real estate mortgage loans should be made on the basis of a percentage of the appraised value of the mortgaged property at the time the loan is granted. In periods of increasing property values, an expansion of lending activity may occur in the form of subordinate mortgages (second liens or second trusts).

5.18 The NCUA's *Credit Manual for Federal Credit Unions* recommends that each real estate loan file should contain—

- A loan application that reveals the amount of credit requested, the purpose of the credit, and the applicant's signature.
- The signature and approval notations of the credit committee or the loan officer.
- Current financial statements.
- Documentation by the credit committee or the loan officer of the analysis of the loan application, including verification of deposits and employment.
- Appraisal reports by a qualified appraiser.

- Evidence of clear title from a title insurance policy or attorney opinion.
- A real estate note that is properly executed and recorded.
- Evidence of current hazard insurance sufficient to pay the mortgage balance, with a standard mortgage clause in favor of the credit union.

5.19 Additionally, documents may be required by other federal and state regulations. These documents may include truth-in-lending disclosures, settlement statements, notices of recision, statement of flood insurance requirements, and applicable government agency guarantees.

Other Loans

Loans Collateralized by Savings Accounts

5.20 Credit unions often make loans secured by savings accounts. The promissory note for such a loan usually provides for assignment of the savings account to the credit union, and it normally entitles the credit union to withdraw funds from the account to pay off the loan balance and accrued interest if the borrower defaults. Credit union management should establish a system to restrict access to assigned savings accounts to prevent unauthorized withdrawals. Furthermore, pledged savings accounts should clearly indicate the collateral withdrawal restrictions.

Agricultural Loans

5.21 Agricultural loans may be secured by farm machinery and equipment, livestock, or crops. These loans require special knowledge of farm operations and may involve the following underwriting considerations:

- Existence of prior liens or security interests
- Equity or down payment amounts
- Seasonal nature of farm operation
- Insurance coverage
- Financial condition of borrower

Business Loans

5.22 A business loan normally is secured by the assets of the borrowing organization, and the proceeds of the loan generally are used to acquire a business or business assets or to finance the operation of a business.

Education Loans

5.23 Credit unions must apply to the appropriate insuring agency for a contract or authorization to make insured student loans. Credit unions may also sell or pledge insured student loans to the Student Loan Marketing Association (Sallie Mae). The terms and underwriting provisions are subject to the policy of the insuring agency.

Accounting

5.24 The general ledger control accounts should be supported by subsidiary records, which may consist of manually or machine-posted ledger cards or computer-prepared listings. A single subsidiary record may contain all pertinent information relating to a loan, including escrow balances for real estate loans, interest rate and loan payment status for installment loans, and the amount of monthly payments. Conversely, it may be necessary to refer to a number of separate records to obtain all necessary loan information.

5.25 Credit unions may carry a *loans-in-process* account that represents the undisbursed portion of mortgage loans. This account should be supported by a subsidiary ledger containing an individual account for the undisbursed portion of each mortgage loan.

5.26 Some credit unions maintain ledgers in which all members' liability transactions are posted. The ledger presents the cumulative total of all borrower liabilities, including direct and indirect liabilities as maker, endorser, or guarantor. The ledger provides a readily available source for obtaining information relating to an individual member's total commitment to the credit union.

5.27 Interest income on loans normally is credited to operating income, based on the outstanding principal amount of the loans. Interest may be calculated and collected on either a 360- or 365-day basis per year. The auditor should be alert to a credit union's policy of permitting grace periods for payments since some credit unions, to ease the task of computing interest, may not assess additional interest or late charges for a short period following a due date.

5.28 A credit union may suspend accrual of interest income on a loan when the payment of interest has become delinquent or collection of the principal has become doubtful. Such action is prudent and appropriate. Regulatory guidelines for nonaccrual loans have been established by supervisory agencies.

5.29 Although placing a loan in a nonaccrual status, including loans accruing at a reduced rate, does not necessarily indicate that the principal is uncollectible in whole or in part, a re-evaluation of collectibility of principal and previously accrued interest generally is warranted. If amounts are received on a loan on which the accrual of interest has been suspended, a determination should be made about whether the payment received should be recorded as a reduction of the principal balance or as interest income.

5.30 If the ultimate collectibility of the principal, wholly or partially, is in doubt, any payment received on a loan on which the accrual of interest has been suspended should be applied to reduce principal to the extent necessary to eliminate such doubt.

Loan Origination Fees

5.31 FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases,* establishes the accounting for nonrefundable fees and costs associated with lending, committing to lend, or purchasing a group of loans. It is applicable to the types of transactions covered herein.

Credit Card Fees

5.32 Some credit unions charge a periodic fee to credit card holders. Such fees, when material, should be deferred and amortized over the term to which the fee relates.

Loan Participations, Sales, and Purchases

5.33 Federal credit unions may—

- Purchase, sell, or pledge, to any source, eligible loans of its members.
- Purchase eligible loans of a liquidating credit union's members.

- Originate or take part in the granting of participation loans.
- Purchase members' student loans from any source.
- Purchase members' real estate loans from any source.

5.34 The last two items are intended to facilitate the packaging of a pool of loans for sale or pledging in the secondary market. Federal or state regulations may prescribe an overall limit of purchase loans, such as the 5-percent limit of regulatory capital for federal credit unions.

5.35 Servicing arrangements generally provide for the servicing credit union to maintain all records related to the servicing agreement, to assume responsibility for billing mortgagors and collecting periodic mortgage payments, and to perform all other activities necessary to the mortgage servicing function.

5.36 Serviced loans may be originated by the servicing credit union itself or by other financial institutions. Loans originated by the servicing credit union may be sold, in whole or in part, to investors, but the servicing activities are retained by the seller credit union. In any of the foregoing arrangements, the credit union receives as compensation a servicing fee, normally expressed as a percentage of the principal balance of the outstanding loans.

5.37 A credit union occasionally may sell loans at servicing fee rates significantly different from current rates. FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, sets forth the recommended accounting treatment for loans sold at a servicing fee rate significantly different from current rates. The statement concludes that an adjustment to the sale price is required whenever the effect on operating results is significant. Such adjustments would result in deferred amounts, to be amortized to servicing fee income over future years. In addition, if current servicing fees are expected to be less than estimated servicing costs over the estimated life of the mortgage loans, the expected loss on servicing the loans shall be accrued at that date.

5.38 Gains or losses are usually recognized at the time the loans are sold. However, if at the end of a reporting period it is apparent that a credit union intends to sell certain loans and that the anticipated sale will result in a loss, the credit union should establish an allowance for losses, which is deducted from the related asset in the statement of financial condition.

5.39 In accounting for sales of loans or participations, the objectives are to recognize in the year of sale the economic gain or loss from the transaction and to avoid including in the year of sale income or expense attributable to a future period. Consequently, when loans are sold outright and are not to be serviced by the selling credit union, the gain or loss is measured by the difference between the selling price and the carrying amount of the loans sold (less applicable deferred loan fees, if any). If loans sold are to be serviced by the selling credit union, adjustment of the selling price to provide a current servicing fee may be required (as discussed earlier in this section).

5.40 Because of the variety of arrangements under which loan participations are sold, it is important to consider, in addition to the stated selling price, the terms of sale, the effective yield to the purchaser, and the arrangements for servicing. A premium or a discount may result when a participation is sold at a price equal to the carrying amount of the loans included in the participation sale and the seller agrees to pay the purchaser a rate of interest greater or less than the loan's stated rate of interest. In such cases the premium or discount should be represented by the discounted amount of the difference between the future interest to be collected by the seller and the interest to be paid to the purchaser after considering future servicing revenues and costs. The FASB's Emerging Issues Task Force has considered several issues relating to accounting for and reporting of loan and risk participations. Guidance issued as a result of the task force's deliberations should be considered in auditing such transactions.

5.41 The principles and guidelines set forth in APB Opinion No. 21 apply to premiums and discounts. The opinion sets forth the method of amortization and financial statement presentation and disclosure.

5.42 Also, guidance is provided in FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse.*

Financial Statement Presentation

5.43 Loans historically have been presented in the statement of financial condition in an aggregate amount. Note disclosures should include a breakdown of loans by major types of lending activities. Consideration should also be given to the need for note disclosure of other information, such as maturities for significant categories of loans and the amounts of loans at fixed rates of interest and at floating rates of interest. Each credit union's share of a participation loan should be classified according to the major type of lending activity represented by the loan.

5.44 Credit unions should also include in their financial statements—

- The undisbursed portion of mortgage loans deducted from the related loans and disclosed either in the statement of financial condition or in the notes.
- Accrued loan interest receivable presented in the caption "Other Assets" or as a separate category of assets.
- Allowances for loan losses and unamortized loan origination and commitment fees, which represent an adjustment of yield, deducted from related loan balances.
- The principal amount of nonaccrual loans disclosed, if material, in the notes.
- Loans to insiders, if material, in the notes. The terms of such loans should also be disclosed if such loans were made on other than normal business terms. In addition, the credit union should consider the need to disclose information on loans to organizations with which officials and employees are affiliated. FASB Statement No. 57, *Related Party Disclosures,* establishes requirements for related party disclosures.

Auditing

Objectives

5.45 Certain significant audit objectives are common to all types of loans and include obtaining evidential matter to support the assertions that—

- Loan balances are reasonably stated as of the date of the financial statements being audited.
- The allowance for loan losses is adequate to provide for anticipated losses (see chapter 6).
- Income and related accrued interest receivable and deferred discount (unearned discount) are stated in conformity with generally accepted accounting principles.

- Loans are owned by the credit union.

Procedures Common to All Types of Loans

5.46 The auditor reviews lending policies and inspects documents supporting loans. Specifically, the auditor selects a sample group of loans from all significant loan categories and performs detailed tests on them. Although larger loans are commonly emphasized, a sample that is selected should be representative of the loans granted by the credit union. The tests normally include inspection of the executed notes, loan applications, financial statements of borrowers, and other credit information and supporting documentation appropriate to the types of loans being examined. Also, the auditor may check for appropriate approvals contained in the loan files and records of the loan officer and in minutes of the meetings of the board of directors or credit committee. Regulations for loans to officials may require approval by the board of directors.

5.47 After the underlying subsidiary loan records are balanced with the general ledger control accounts, the auditor should request confirmation of a representative sample of loan balances directly with the borrowers. Negative confirmations are often used if (a) the combined assessed level of inherent and control risk is low, (b) a large number of small balances is involved, and (c) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration. Positive confirmation procedures should be used for larger loans and for loans that require confirmation of information, such as amount and type of collateral and amount of escrow deposits, in addition to the loan balance. (SAS No. 67 provides guidance about the confirmation process in audits performed in accordance with generally accepted auditing standards.)

5.48 The results of the detailed inspection of a sample group of loans assist the auditor in determining that loans actually exist. To evaluate the collectibility of loans, the auditor should perform separately designed tests. (See chapter 6.)

5.49 The audit often includes procedures to test controls over credit union policies relating to loans charged off. The loan file should include documentation indicating the following:

- Approval of the charge-off by the board of directors
- Collection history of the loan
- Disposition of collateral
- Correspondence with borrower

5.50 Accrued interest receivable and interest income are often tested for a representative sample group of loans. Audit procedures typically include recalculation of accrued interest, balancing of subsidiary records to the general ledger control accounts, and testing of interest income for a selected period. The auditor should also test interest income overall by relating income for the period under examination to the average loan balance by type of loan and comparing the resulting yield to interest rates in effect during the period. Confirmation requests may include appropriate information relating to accrued interest receivable, interest rates in effect as of the confirmation date, and collateral.

5.51 The auditor should normally review loans to officials and employees as well as loans to organizations with which these individuals are affiliated. The auditor may correlate information developed through other audit tests with reports of federal and state supervisory agency examiners and with records maintained by the credit union relating to potential conflicts of interest. Such credit union records may include summaries of the business interests of officials and employees.

Procedures for Specific Types of Loans

5.52 *Collateralized Loans.* The auditor should test the physical existence and proper assignment to the credit union of collateral supporting collateralized loans. The examination of loan documentation should include tests of the adequacy of both the current value of collateral in relation to the outstanding loan balance and, if needed, insurance coverage on the loan collateral. For loans involving guarantees, the auditor should normally read the financial statements and other evidence of financial condition of cosigners and guarantors and consider confirming with guarantors. Controls over collateral typically would be evaluated, with particular emphasis on controls surrounding negotiable collateral.

5.53 *Line-of-Credit Loans.* The auditor often performs the following tests of lending policies:

- Determine the frequency of review of established line-of-credit loan files.
- Determine whether maximum credit limits are established on the individual member's ability to pay.
- Review the board of directors' policies for advances that exceed an individual borrower's approved credit limit and for requests to increase that approved limit.
- Determine that collateral, if applicable, is pledged according to the board of directors' policy.

5.54 *Credit Card Loans.* If the credit union is involved in credit card operations, including credit card issuance and processing transactions, the auditor should obtain a sufficient understanding of the internal control structure over credit card operations to plan the audit. Procedures for the review of credit card operations depend on the degree of credit union involvement. If the credit union assumes the customer receivable, a review of lending policies, confirmation of members' balances, and tests of interest and service charges, delinquencies, and charge-offs may be appropriate.

5.55 *Mortgage Loans.* The auditor's tests of mortgage documents frequently emphasize loans made since the date of the last audit, and they are supplemented by limited tests of documents relating to mortgage loans originated in prior periods. The auditor should consider coordinating confirmation of the unexpended balances of escrow funds and mortgage loan principal balances with borrowers. The activity in the escrow accounts should normally be tested. In addition, the auditor should review the procedures the credit union follows for determining that adequate fire and other hazard insurance coverage is carried, that real estate taxes are currently paid, and that properties are in good condition.

5.56 *Servicing.* SAS No. 44,* *Special-Purpose Reports on Internal Accounting Control at Service Organizations,* provides guidance on the preparation and use of a special-purpose report on certain aspects of internal accounting control of an organization providing certain services to a client whose financial statements the CPA has been engaged to audit. The statement requires the CPA to consider the division of accounting and control functions between the client organization and the service organization. If no special-

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* SAS No. 70, *Reports on the Processing of Transactions by Service Organizations,* supersedes SAS No. 44 and is effective for service auditors' reports dated after March 31, 1993.

purpose reports are received and the amount of serviced loans is material, the CPA should consider performing alternative procedures necessary to determine whether adequate independent confirmation and other testing has been performed.

5.57 *Loan Participation.* The auditing procedures for participations in loans purchased are similar to those for direct loans, except that requests for confirmation of the balance of collateral, if any, are sent to the managing (lead) credit union. Loan files for participations should be available at the credit union and should contain pertinent documents (or copies), including credit files supporting loans in which it has purchased participations from other credit unions.

5.58 Details for participations in a credit union's direct loans sold should be confirmed with the participating purchasers. Confirmation of the amount of each purchaser's participation in the loans should be requested. However, care should be exercised in requesting confirmation of participations sold. Since the borrower normally deals only with the credit union originating the loan, the gross balance, including amounts sold to other credit unions, should be confirmed with the borrower.

5.59 Internal control structure considerations for loans are listed in Appendix B of this guide.

Chapter 6

Allowance for Loan Losses

6.01 The allowance for loan losses represents management's estimate of loan and direct-financing lease losses in a credit union's portfolio. If the allowance is less than losses currently anticipated, the additional amount needed to increase the allowance should be recognized as a charge to operating expenses in the current period.

Accounting

6.02 A credit union should maintain a reasonable allowance for loan losses, applicable to all categories of loans, through periodic charges to operating expenses. The amount of the provision should be adequate to cover estimated losses inherent in the loan portfolio; that is, the propriety of the accounting treatment should be judged according to the adequacy of the allowance determined on a consistent basis, not the provision charged to operating expenses.

6.03 Loans should be written off when they are deemed uncollectible, and that practice should be applied consistently in all interim financial reporting periods.

Financial Statement Presentation

6.04 The allowance for loan losses that is accumulated through charges to operations should be deducted from the related assets in the statement of financial condition. The notes to financial statements should include a summary of activity in the allowance for loan losses account for the period.

Auditing

Objective

6.05 The significant objective of the audit of the allowance for loan losses is to evaluate the reasonableness of the recorded allowance.

Procedures

6.06 As previously discussed, the allowance for loan losses represents an amount that, in management's judgment, approximates current amounts of loans that will not be collected based on all relevant conditions. The auditor's considerations should not be limited to previous collection experience but should also include estimates of the effects of changing business trends and other relevant factors. Care should be exercised to avoid reliance on, or emphasis on, mechanical formulas that incorporate only collection experience.

6.07 Evaluating the adequacy of the loan loss allowance involves considering loan collectibility, that is, whether the loan will be repaid or the principal otherwise recovered. The answer may depend on, among other factors, the borrower's financial ability as indicated in past and projected earnings and cash flow, credit and payment history, net realizable value of the loan collateral, and the financial responsibility of endorsers or guarantors. Most often a combination of these factors determines the soundness of a particular loan.

6.08 The auditor is responsible not for calculating the amount of the allowance but for obtaining evidence that management has recorded an adequate allowance, based on available information and all relevant factors bearing on loan collectibility.

6.09 Since loans generally are the credit union's largest single class of assets and present the highest potential for loss, the auditor may encounter a number of groups, in addition to state and federal supervisory agency examiners, that have an interest in evaluating the collectibility of the loan portfolio. Interested groups may include the credit committee, supervisory committee, internal auditor, and board of directors. The groups' specific responsibilities in loan review vary, depending on the size of the credit union and on the directives of the board of directors, the credit committee, and management. The auditor's testing is most efficient when it is designed to maximize the use of information available from these sources, and the auditor may consider their efforts when setting the nature, extent, and timing of tests.

6.10 In evaluating the reasonableness of the allowance, the auditor should consider the following:

- Current trend of delinquencies
- Loans classified by supervisory agency examiners
- Loans with excessive renewals and extensions
- Absence of current financial data relating to borrowers and guarantors
- Borrowers and guarantors experiencing such problems as operating losses, marginal working capital, and inadequate cash flow, or business interruptions, such as involuntary conversions due to fire loss or condemnation
- History of prior loan losses
- Loans secured by collateral not readily marketable or susceptible to deterioration in realizable value
- Loans to entities in industries experiencing economic instability
- Inadequately documented loans

6.11 If the auditor is to rely on delinquency reports, such as an aging of the loan balances by the degree of delinquency, the information in these reports should be tested to assist the auditor in determining the degree of reliance to be placed on them.

6.12 The auditor is not required to test individually the collectibility of each loan in a credit union's portfolio. The audit procedures should be designed to test the overall collectibility of the portfolio and should be performed primarily on selected loans. In establishing the scope of the work to be performed, the auditor should consider the composition of the loan portfolio, current growth trends in specific loan classifications, previous loss and recovery experience (including timeliness of charge-offs), his or her understanding of internal control structure policies and procedures over lending, management's procedures for loan review and classification, and such factors as economic and environmental conditions.

6.13 Although the auditor's primary responsibility when reviewing the allowance for loan losses is to evaluate its adequacy as a whole, practical considerations may dictate that the review be directed to the separate types of loans that constitute the credit union's portfolio. Since the risk and other inherent characteristics of primary loan categories vary, the nature and extent of the separate reviews can be expected to vary as well.

6.14 Loan categories represented by large volumes of relatively small loans with similar characteristics, such as installment loans and retail credit loans, generally are evaluated on a group basis. The auditor usually is more concerned with the effectiveness of, and adherence to, sound procedures related to such loans as a group rather than with a critical appraisal of each loan. When controls are effective and no unusual circumstances exist, the testing of procedures and review of delinquency status reports should permit a conclusion to be drawn about the adequacy of the allowance required for these loan classifications. In evaluating the adequacy of the portion of the allowance attributable to those loans, use of historical average annual charge-off experience should be considered in light of the average remaining lives of loans, consistency of loan policy, and current economic conditions.

6.15 In contrast, an evaluation of real estate and other large-balance loans normally requires a more detailed review. A relatively small number of potential losses can often significantly affect the adequacy of the allowance. The auditor may select and review a certain number of loans in excess of a specific amount, with particular attention to problem loans previously identified by the credit union's internal review procedures, the auditor's prior experience, and loans commented on by supervisory agencies. Loans selected for review may be further stratified by type of loan, depending on the auditor's assessment of the relative exposure to loss presented by the various categories.

6.16 The total amount, number, and types of loans reviewed, expressed as a percentage of the loan portfolio, will vary by credit union. In making such decisions, individual judgment, based on existing facts and circumstances, should prevail. Such factors as trends in the level of delinquent loans, local and general business conditions, past loss experience, and credit union lending and loan review policies should be considered case by case. With respect to the collectibility of members' loans, the auditor should be alert to the possible effect of announced plant closings, shutdowns, or layoffs by the common bond employer.

6.17 Audit procedures for the allowance for loan losses should also include testing of unused loan commitments, direct financing leasing arrangements, and accrued interest receivable.

6.18 For purposes of expressing an opinion on the financial statements, the auditor is concerned with the amount at which loans are stated in the aggregate. Therefore, the specific allowances identified with individual loans and groups of loans should be supplemented by an amount provided for inherent loan portfolio losses not specifically provided for. This amount should be based on judgments regarding risk of misstatement in the specific allowance for individual loans and groups of loans, exposures existing in the credit union's loan portfolio, and other relevant factors consistently applied.

Regulatory Compliance

6.19 For regulatory purposes, credit unions have historically used either the *experience method* or the *adjustment method* to calculate their allowance for loan losses. Although the application of either method may or may not result in substantially the same allowance as management's estimate for the loan loss allowance, management should report a loan loss allowance in the financial statements prepared under generally accepted accounting principles that is adequate to cover all estimated losses in the loan portfolio.

6.20 The NCUA's *Accounting Manual For Federal Credit Unions* describes these methods as follows:

Experience Method

Under this method, the amount needed in the allowance for loan losses is based on the credit union's loss experience and its average loan balances for the current year plus the five preceding calendar years and the average maturity of all loans outstanding.

Adjustment Method

The credit union will perform a review of all loans delinquent two months or more and loan derived assets to determine its best feasible estimate of potential losses which will be sustained in collection and as to the adequacy of the Allowance for Loan Losses. The estimate should be based on the best judgment of the credit union officials taking all pertinent factors into consideration, including loan delinquency status, collection experience of the credit union, unusual economic conditions that may affect collectibility, availability of endorsers, pledged shares and/or other collateral or security, insured FHA or educational loan coverage, and the general credit reputation of the borrowers.

Chapter 7

Other Assets

7.01 The following items may constitute other assets in a credit union:

- Property and equipment
- Real estate or other property acquired in satisfaction of members' loan obligations*
- Accounts receivable
- Prepaid expenses (for example, prepaid membership dues, share insurance, and assessments)
- Payroll deductions receivable
- Investment in data service centers
- Investment in service organizations
- Monetary control reserve deposits
- Accrued income accounts

Accounting

Property and Equipment

7.02 This category includes the following:

- Land
- Building
- Furniture and equipment
- Leasehold improvements
- Leased assets

Property acquired in satisfaction of members' loan obligations should not be included in property and equipment, but rather under the other assets caption.

7.03 Under section 107(4) of the Federal Credit Union Act, as well as many state statutes, credit unions are authorized to purchase, hold, and dispose of property necessary or incidental to their operations. Credit unions are limited by regulatory authorities to a maximum investment in property and equipment. They are also prohibited from acquiring real property from related parties.

7.04 Property and equipment should include all costs related to the acquisition of the property, including transportation and installation costs. If a credit union constructs property, cost includes all direct construction costs together with architects' fees, costs of excavations, and supervision of construction. FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects,* addresses the capitalization of property taxes and other carrying charges (excluding interest) incurred during construction. FASB Statement No. 34, *Capitalization of Interest Cost,* sets forth criteria for capitalization of interest. FASB Statement No. 13 provides guidance for accounting for properties subject to leases (either operating or capital).

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* SOP 92-3, *Accounting for Foreclosed Assets,* provides guidance on measuring foreclosed assets and in-substance foreclosed assets after foreclosure. SOP 92-3 should be applied to foreclosed assets in annual financial statements for periods ending on or after December 15, 1992 and is included as Appendix E of this guide.

7.05 Typical depreciation methods used by credit unions include the following:

- Straight-line
- Sum-of-the-years' digits
- Declining balance
- Composite

Sale and Leaseback Arrangements

7.06 In recent years a number of credit unions have entered into sale and leaseback transactions involving their operating facilities. Such transactions should be carefully considered, especially related party transactions.

7.07 The following literature contains substantive accounting guidance:

- FASB Statement No. 13, *Accounting for Leases*
- FASB Statement No. 28, *Accounting for Sales with Leasebacks*
- FASB Statement No. 66, *Accounting for Sales of Real Estate*
- FASB Statement No. 98, *Accounting for Leases*
- APB Opinion No. 21, *Interest on Receivables and Payables*

Other Assets

7.08 Credit unions may have equity investments in subsidiary companies generally described as service organizations. The amount of investment permitted in service organizations is governed by federal or state regulations. The financial statements of subsidiaries should be included in the consolidated financial statements in accordance with the provisions of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, as amended by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, and APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*.

Financial Statement Presentation

7.09 Property and equipment are normally shown as a single caption on the statement of financial condition, net of accumulated depreciation, and amortization. However, if the individual categories of assets are material, separate captions should be used in the statement of financial condition or in the notes to the financial statements. In either case the basis of valuation should be indicated in the statement of financial condition or in the notes. Accumulated depreciation and amortization may be shown on the statement of financial condition as a separate item deducted from the related assets, parenthetically if the assets are reported at a net amount, or in the notes to the financial statements.

7.10 Lease commitments should be disclosed in the financial statements in accordance with FASB Statement No. 13 and its amendments and interpretations.

7.11 Appropriate information should be obtained for the total estimated cost of a major expansion program and for the unused amounts of related commitments. These commitments should be disclosed in notes to the financial statements if the amounts are material.

7.12 Items classified as "Other Assets" may be presented as a single amount under that statement of financial condition caption. However, items that are individually material in amount should be presented separately under that caption. Items classified as "Other Assets" are generally presented last in the asset section of the statement of financial condition.

Auditing

7.13 The audit objectives, internal control structure considerations, and audit procedures for credit union property and equipment and other assets are similar to those for other business enterprises.

7.14 Typical audit procedures for property and equipment include the following:

- Examine supporting documents for major additions, sales, retirements, and other adjustments to carrying value.
- Examine deeds and title insurance policies.
- Review insurance policies and coverage.
- Determine compliance with capitalization policy.
- Test computation of depreciation amounts.
- Determine compliance with regulatory property and equipment investment limitations and restrictions on sale and leaseback transactions.
- Test compliance with lease contractual provisions.

7.15 For other assets the auditor's procedures include the following:

- Examine evidence supporting the carrying amount of other assets, as well as the adequacy of the allowance for losses if any.
- Send confirmation requests, as appropriate.
- Inspect real estate or review applicable appraisals and legal documents for foreclosed property.

7.16 Internal control structure considerations for other assets are listed in Appendix B of this guide.

Chapter 8

Savings Accounts

8.01 A credit union is funded primarily by members' savings deposits, which may be referred to as shares, share drafts, or share certificates. Most credit unions offer various savings opportunities normally restricted to credit union members, which may be categorized as savings or certificates.

8.02 Common types of interest-bearing savings accounts include the following:

- *Regular* (statement or passbook). An account that does not require a holder to maintain a balance greater than a minimum balance and does not require notice of intent to withdraw.
- *Share draft.* An account from which the holder is authorized to withdraw savings by means of a negotiable or transferable instrument or other order.
- *Money market.* A deposit account with no maximum rate of interest and with limited transfers permitted.
- *Public unit.* Deposits made by a governmental unit in a savings or certificate account.
- *Nonmember.* Savings of other federally insured credit unions, nonmember individuals, or nonprofit organizations.

8.03 Certificate types include the following:

- *Jumbo.* An account with denominations of $100,000 or more.
- *Money market.* An account with varying maturities.
- *Minimum deposit.* An account with a required minimum deposit.
- *Notice.* An account with a notice of withdrawal and regular additions.
- *Individual retirement account (IRA).* A tax-free account for members (may also be a savings account).

Accounting

8.04 The members of a credit union are also its owners. The savings of the owners-members are frequently referred to as share accounts; the interest paid on the accounts is often called a dividend.

8.05 Credit unions historically have treated members' savings (shares) as equity for regulatory purposes. The amount on deposit in a member's account bears no relationship to his degree of ownership or control in management of the credit union's activities. Credit unions are cooperative organizations, with each member entitled to one vote in the election of officials and other matters presented to the membership. Members are entitled to a pro-rata distribution of assets in excess of liabilities, with the exception of shares due its members, in the event of a liquidation.

8.06 Savings accounts in a credit union should be classified as liabilities on the entity's statement of financial condition. This presentation is consistent with the prevailing practice in mutually owned savings and loan associations and savings banks. Furthermore, it is consistent with the concept of liabilities expressed in FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements,* a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2).

8.07 Member earnings on savings accounts should be recorded as expenses, regardless of their designation as interest or dividend expense. This expense represents the cost of funds acquired from members.

8.08 Individual accounting records and documentation are maintained for each member's savings account. The records may be individual ledgers; however, many credit unions maintain these records on EDP equipment operated by the credit union or a service bureau. Each account is assigned a number, and membership (signature) cards are generally filed alphabetically to facilitate cross-referencing. Periodically, members are provided with statements of account activity, which detail additions, withdrawals, and adjustments.

8.09 Credit unions maintain subsidiary ledgers to record their members' deposits, classified by type of account. Savings accounts, commonly referred to as shares, are interest (dividend)- bearing accounts subject to withdrawal on notice by the member. These accounts are paid interest (dividends) in accordance with credit union policy. The rates, terms, and conditions are determined periodically by the board of directors. Credit unions may have share draft accounts available to their members that pay interest at a predetermined rate, and periodic statements are issued listing all transactions. Credit unions may also offer savings certificates with various maturities and pay several rates of interest (dividend) in accordance with board policy and/or current federal and state regulations. These certificates pay a certain rate, provided the funds remain on deposit for the agreed-upon term. Often there are penalties for early withdrawal.

Financial Statement Presentation

8.10 Savings accounts of credit union members should appear in the liabilities section of the statement of financial condition. The classes of savings should be reported in a note to the financial statements. Interest paid or accrued, commonly referred to as dividends, should be treated as an expense in the statement of income, and interest (dividends) payable to members should be shown as a liability.

Auditing

Objectives

8.11 The principal objective in testing a credit union's savings accounts is to obtain reasonable assurance that the savings account balances and related expense accounts are fairly stated in conformity with generally accepted accounting principles and that the accounts are properly classified in the financial statements.

Procedures

8.12 Audit procedures include agreeing the underlying subsidiary deposit records with the general ledger control accounts and requesting, on a test basis, confirmation of account balances with members.

8.13 Internal control structure considerations for savings affecting the audit scope are detailed in Appendix B of this guide.

8.14 Trial balances of the detailed savings account ledgers (EDP or manual) should be tested for mathematical accuracy. The auditor should maintain control of the trial balances and ledgers to prevent unauthorized adjustment of the accounts until he completes his testing. The auditor may decide to perform certain audit procedures at an interim date (see chapter 2).

However, before doing so, the auditor should assess the difficulty in controlling the incremental audit risk. SAS No. 45, *Omnibus Statement on Auditing Standards—1983,* "Substantive Tests Prior to the Balance-Sheet Date," provides guidance in making that assessment.

8.15 Additional tests may include, but are not necessarily limited to, the following:

- Review the control over origination of, and access to, signature cards.
- Test the daily deposit and withdrawal slips in relation to receipts and disbursement totals.
- Compare the withdrawal slips to the applicable subsidiary record and signature cards.
- Review the control over origination of, and access to, mailing address files.
- Review the control over mail receipts.
- Test accounts for compliance with the credit union's policy regarding early withdrawal penalty interest recognition.
- Review dormant accounts and transactions relative to deceased members' accounts, particularly life savings insurance claims.
- Test compliance with Internal Revenue Service Form 1099 reporting.
- Test compliance with state escheat laws.
- Test service charge income in accordance with board policy.
- Test transactions and restrictions on savings accounts pledged as collateral for loans.

8.16 Confirmation of savings account balances should be requested from members. The extent and type (positive and negative) of confirmations and methods of selection are left to the auditor's discretion. Confirmation requests generally should be prepared as of the date selected for performing other auditing procedures for subsidiary ledgers. They ordinarily should include a representative sample of active and dormant accounts, large and unusual accounts, and accounts closed during the audit period. SAS No. 67, *The Confirmation Process,* provides guidance about the confirmation process in audits in accordance with generally accepted auditing standards.

8.17 Some members may have instructed the credit union that their accounts are on a "no mail" basis. There should be a written request from the member authorizing the "no mail" status. Those accounts and accounts for which confirmation requests are returned undelivered by the postal authorities should be subjected to alternative procedures, such as confirmation by personal contact with the member or a review of account activity. If alternative procedures are not practicable, the auditor should consider whether a scope limitation exists.

8.18 Accrued interest (dividend) payable, interest expense, and service charge income should be tested in connection with the audit of savings accounts. Test procedures for interest on savings include the balancing of subsidiary records with the general ledger controls, recalculation of interest paid and accrued interest payable, and the testing of interest expense for a specified period. Overall tests of interest may be performed by relating interest expense for the period under audit to the average balance of the respective interest-bearing savings accounts and comparing the resulting yields to interest rates in effect during the period. Service charge income should be tested to determine that the fees were charged in accordance with the credit union's policy.

8.19 On March 28, 1985, the NCUA amended and retitled section 701.12 of its rules and regulations concerning supervisory committee audits and verifications. At the same time, the board rescinded Interpretive Ruling and Policy Statement (IRPS) 80-12, issued in 1981, which established minimum standards for the use of statistical sampling for confirmation of members' accounts in federally insured credit unions. As a result of this amendment, item (e) was added to section 701.12 and states:

> (e) The verification of members' accounts shall be made using any of the following methods:
>
> (1) A controlled verification of 100 percent of members' share and loan accounts;
>
> (2) A controlled random statistical sampling method that accurately tests sufficient accounts in both number and scope to provide assurance that the General Ledger accounts are fairly stated and that members' accounts are properly safeguarded. The sampling procedure must provide each member account an equal chance of being selected.
>
> Records of those accounts verified will be maintained and will be retained until the next verification of members' accounts is completed.

8.20 Thus, amended section 701.12, as did the rescinded IRPS 80-12, requires either confirmation of all members' accounts or selection of a sample for confirmation using a statistical sampling method.

8.21 Conversely, SAS No. 39 provides that either statistical or nonstatistical sampling, when properly applied, can provide sufficient evidential matter. Consequently, audits of federally insured credit unions performed in conformity with GAAS would not prohibit confirmation of accounts using a nonstatistical sampling method; however, verification of accounts in compliance with NCUA rules and regulations would require use of statistical sampling.

Chapter 9

Borrowed Funds

Types of Borrowed Funds

9.01 There are several categories of borrowed funds, including the following:

- Notes payable (to other financial institutions, the Central Liquidity Facility, the Federal Reserve Bank)
- Promissory notes to members and nonmembers
- Mortgages payable or capitalized lease obligations
- Federal funds payable
- Treasury tax and loan note option account
- Reverse repurchase agreements

9.02 Credit unions do not issue commercial paper, mortgage-backed bonds, or subordinated debentures.

Notes Payable

9.03 Like other business enterprises, credit unions generally borrow money for short-term operational needs. A credit union may obtain lines of credit from other financial institutions. Such borrowings are limited by regulatory authorities to a percentage of savings and equity. The Central Liquidity Facility (CLF), established by the NCUA at the direction of Congress, was created to improve general financial stability by meeting the liquidity needs of credit unions. Members of the CLF are required to purchase stock in the CLF. Borrowing from the CLF can be arranged for individual credit unions directly or through an intermediary, referred to as a Corporate Central Credit Union, which then acts as its agent. Credit unions have access to the discount window of the Federal Reserve System.

Promissory Notes (Notes)

9.04 Notes, a special form of time deposit, generally bear interest at rates higher than those paid on savings accounts. Unlike savings accounts, notes may be offered ("sold") to nonmembers as well as to members of the credit union, although the majority of notes are usually sold to members.

9.05 The higher interest rates are sometimes limited to notes held to maturity; some credit unions impose an early-withdrawal penalty for notes not held to maturity.

Mortgages Payable

9.06 Credit unions sometimes finance expansion programs by using traditional mortgages secured by real estate owned.

Federal Funds Payable

9.07 These loans generally are one-day loans in the form of balances at Federal Reserve Banks. A credit union may borrow federal funds on a daily basis or may loan them when surplus funds permit such activity.

Treasury Tax and Loan Note Option Account

9.08 Credit unions may elect to transfer amounts from the Treasury tax and loan remittance option account to the Treasury tax and loan note option account. These deposits are subject to withdrawals and are evidenced by an open-end, interest-bearing note maintained at the Federal Reserve Bank.

Reverse Repurchase Agreements

9.09 These transactions involve an agreement to sell and repurchase identical certificates within a specified time at a specified price. Guidance for certain types of these transactions is provided in SOP 85-2, *Accounting for Dollar Repurchase—Dollar Reverse Repurchase Agreements by Sellers-Borrowers.*

Financial Statement Presentation

9.10 Individual borrowed fund types should be presented separately in the liability section of the statement of financial condition if their amounts are material. Notes to the financial statements should disclose the following:

- Interest rates
- Due dates
- Pledged collateral or compensating balance agreements
- Restrictive loan agreement covenants if significant
- Five-year maturity schedule as required by FASB Statement No. 47, *Disclosure of Long-Term Obligations*

Auditing

Objective

9.11 The principal audit objective for borrowed funds is to obtain reasonable assurance that liabilities and related expense accounts are fairly presented in conformity with generally accepted accounting principles and that required disclosures have been made in the financial statements or in the notes.

Procedures

9.12 The extent of audit procedures for borrowed funds depends on the circumstances of the engagement. Several, but not necessarily all, auditing procedures that may be considered when examining borrowed funds are the following:

- Request confirmation of terms of borrowing with the lender (including, for example, current balance, interest rate, and pledged property).
- Ascertain and request confirmation to determine the existence and terms of lines of credit and compensating balance arrangements.
- Read loan agreements, if applicable, and ascertain compliance with restrictive covenants.
- Examine copies of notes (including cancelled original notes).
- Test interest expense and accrued interest payable.
- Read the financial statements to determine if required disclosures have been made.
- Review minutes of meetings of the board of directors.

9.13 Internal control structure considerations for borrowed funds are listed in Appendix B of this guide.

Chapter 10

Other Liabilities

10.01 Other liabilities of credit unions may include the following:

- Accounts payable
- Accrued interest (dividend) payable
- Accrued wages
- Accrued payroll taxes
- Accrued audit and supervisory agency fees
- Accrued pension costs
- Accrued data processing charges
- Liability for traveler's checks and money orders sold
- Liability to the Federal Reserve Bank for savings bonds sold
- Advance payments by borrowers for taxes and insurance
- Other accrued expenses
- Suspense accounts (items recorded and held subject to clarification and transfer to the proper account, such as unapplied loan payments and savings deposits)

Financial Statement Presentation

10.02 If material, each of the above accounts should be stated separately in the statement of financial condition or in the related notes.

Auditing

10.03 Accounts such as accrued interest (dividend) payable and advance payments by borrowers for taxes and insurance should be audited in conjunction with the audit of the related statement of financial condition account.

10.04 The audit of such accounts as accrued payroll taxes, accrued pension costs, liability to the Federal Reserve Bank for savings bonds sold, and accrued wages often utilizes external reports or returns required by the government or private entity. Confirmation of balances and other details may be necessary, with the government or private entity receiving the reports or returns submitted by the credit union.

10.05 Internal control structure considerations for other liabilities are listed in Appendix B of this guide.

Taxes

10.06 Internal Revenue Code section 501(c)(14)(A) exempts credit unions from federal income taxes. IRS Revenue Ruling *72-37* defines *credit union* for purposes of determining federal income tax status. The auditor should be alert to future changes in the tax status of credit unions as a result of congressional action or IRS rulings or regulations. (See chapter 12 for further discussion of income taxes.)

10.07 Section 122 of the Federal Credit Union Act exempts federal credit unions from federal, state, and local income tax. However, real property and any tangible personal property of federal credit unions generally are subject to state or local taxation to the same extent that similar property is taxed.

10.08 The information return 990, which tax-exempt organizations are required to file with the IRS, is prepared on a consolidated basis by the NCUA from year-end financial reports submitted to it by all operating federal credit unions. Individual federal credit unions therefore are not required to file this return. Some states provide similar services for state-chartered credit unions.

Chapter 11

Equity

11.01 The equity section of a credit union's statement of financial condition typically consists only of retained earnings. Retained earnings are commonly referred to as undivided earnings or undivided profits.

Retained Earnings

11.02 Retained earnings represent accumulated undistributed earnings available to—

- Comply with regulatory reserve requirements.
- Benefit members by offering below-market rates on loans.
- Benefit members by offering above-market rates on savings.
- Provide an equity base.

11.03 The following classifications of retained earnings may exist in a credit union.

Regular Reserve

11.04 This account is created and maintained by application of a regulatory formula that is computed by multiplying a percentage of gross income until the reserve reaches a specified percentage of total outstanding loans and certain other assets, referred to as risk assets. The balance in the reserve account represents a regulatory restriction of retained earnings for loan losses in excess of the allowance for loan losses.

Appropriated Retained Earnings

11.05 The board of directors may restrict an amount of retained earnings for a specific purpose. The amount is normally transferred from unappropriated retained earnings pending resolution of its purpose. The amount would be returned to unappropriated retained earnings when it is no longer necessary. An example is an appropriation for loss contingencies.

Donated Equity

11.06 When a credit union receives a donation of material value, such as property and equipment, the value of this asset should be established by a debit to the appropriate asset account, with a corresponding credit to this separate equity account. Donated assets should be recorded based on the estimated fair market value of the assets at the date of acquisition.

Financial Statement Presentation

11.07 Retained earnings should be shown as a single item on the statement of financial condition. In the notes to the financial statements or in a statement of retained earnings, significant restrictions (such as the payment of dividends) on the use of retained earnings should be disclosed. These restrictions may include those imposed by regulatory reserve requirements, state laws, or credit agreements. In such cases a notation should be made beside the retained earnings account on the statement of financial condition, indicating that the retained earnings are "substantially restricted."

Auditing

11.08 The auditor should become familiar with the reserve requirements of the credit union's bylaws and applicable federal and state regulations, including the NCUSIF insurance regulations.

11.09 The auditor should review the retained earnings accounts for compliance with applicable rules and regulations and should consider whether deviations should be disclosed. The auditor should also consider whether deviations should be discussed with credit union officials and, if required, the applicable supervisory agency.

11.10 The auditor should determine if there are any significant restrictions on the use of retained earnings and whether such restrictions are adequately disclosed in the statement of financial condition or in the notes.

11.11 In the event of a reserve deficiency, credit union operations may be limited by supervisory agencies. These limitations may include establishing special reserves, restrictions on payment of dividends, or liquidation of the credit union.

11.12 Such limitations may give rise to a significant uncertainty regarding the continuation of the entity as a going concern. In such circumstances, the auditor should refer to SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue As a Going Concern,* which provides guidance to the auditor with respect to evaluating whether there is substantial doubt about the entity's ability to continue as a going concern.

Chapter 12

Operating Revenue and Expense

12.01 Income and expenses of a credit union are accumulated in revenue and expense accounts for the current accounting period until they are closed into retained earnings. Most credit unions end their fiscal years on December 31. Income accounts generally are maintained on a functional basis, for example, loans and investments. Expense accounts generally reflect operating expenses that cross functional areas and are grouped for financial statement purposes into categories such as compensation and benefits, occupancy, and data processing. If material, the provision for loan losses should be disclosed separately.

Financial Statement Presentation

12.02 The statement of income may be prepared under either of two concepts:

- *Net interest.* Interest (dividends) on savings and interest on borrowed funds are separately disclosed and subtracted from income from loans and investments to arrive at net interest income. Other expense and income items are then subtracted from and added to net interest income to arrive at net income.
- *Gross income and expense.* All income items are grouped and all expense items are grouped. Total expense is deducted from total income to arrive at net income.

12.03 The illustrative statement in Appendix A presents the net interest concept. Although the AICPA Credit Unions Committee recommends this format, the other form is acceptable.

Auditing

Objectives

12.04 The major audit objectives for operating revenue and expense are to determine that income and expenses are both accumulated properly and presented in conformity with generally accepted accounting principles, including adequate disclosure.

Procedures

12.05 The procedures used to audit a credit union's operating revenue and expense accounts are similar to those for other enterprises having a high volume of transactions.

12.06 SAS No. 56, *Analytical Procedures*, provides guidance for the auditor in the application of analytical procedures. Material fluctuations of income and expense should be investigated and satisfactory explanations obtained. Overall tests of income from loans and interest (dividend) expense on savings should be made.

12.07 Income and expense are often tested in conjunction with the related asset or liability accounts. Some examples are these:

Income or Expense Items	*Asset or Liability Items*
Income items	
Interest on loans	Loans
Fees on loans	Loans
Interest on investments	Investment securities
Expense items	
Interest (dividends) on savings accounts	Savings accounts
Interest on borrowed funds	Borrowed funds
Operating expenses	Cash and accounts payable

12.08 The above items are high-volume, cash-oriented transactions. SAS No. 1, section 150.05, states "cash transactions are more susceptible to irregularities than [many other assets] and the work undertaken on cash may therefore have to be carried out in a more conclusive manner without necessarily implying a greater expenditure of time."

12.09 The auditor should also be aware of the following:

- Certain officials of the credit union are prohibited by law from receiving compensation.
- Although credit unions are exempt from federal income tax (see chapter 10), some state-chartered credit unions may be subject to federal taxes on unrelated business income under sections 512 and 513 of the Internal Revenue Code. Unrelated business income is defined by the IRS as income accruing from activities not substantially related to a credit union's usual business operations. The auditor should be familiar with the provisions of sections 512 and 513 and applicable IRS regulations and revenue rulings to determine the extent of any tax liability.

12.10 Internal control structure considerations for reporting revenue and expense are listed in Appendix B of this guide.

Appendix A

Illustrative Report of the Independent Auditor and Illustrative Credit Union Financial Statements

(The following illustrates the auditor's standard report and one form of currently acceptable financial statements. Other forms of financial statements are acceptable. More or less detail should appear in the financial statements or in the notes, depending on the circumstances. The CPA should be guided by existing auditing standards concerning the report.)

Independent Auditor's Report

To the Board of Directors
Sample Credit Union
Sampletown, U.S.A.

We have audited the accompanying statements of financial condition of Sample Credit Union as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial condition of Sample Credit Union at December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Signature

Office town, U.S.A.
Month Day, 19X3

Sample Credit Union
Statements of Financial Condition
December 31, 19X2 and 19X1

	19X2	*19X1*
Assets		
Loans to members, net of allowance for loan losses (Note 3)	$44,800,000	$40,900,000
Cash	700,000	800,000
Investments (Notes 2 and 6)	5,000,000	7,000,000
Accrued interest receivable	100,000	70,000
Property and equipment (Note 4)	1,050,000	900,000
Central Liquidity Facility stock, at cost	250,000	250,000
Other assets	50,000	40,000
Total assets	$51,950,000	$49,960,000
Liabilities and Equity		
Savings accounts (Note 5)	$42,600,000	$42,460,000
Borrowed funds (Note 6)	5,000,000	4,000,000
Accrued and other liabilities	800,000	500,000
Commitments and contingent liabilities (Note 9)	—	—
Total liabilities	$48,400,000	$46,960,000
Retained earnings, substantially restricted (Note 7)	3,550,000	3,000,000
Total liabilities and equity	$51,950,000	$49,960,000

The accompanying notes are an integral part of these financial statements.

Sample Credit Union

Statements of Income

Years Ended December 31, 19X2 and 19X1

	19X2	*19X1*
Interest income		
Interest and fees on loans	$4,300,000	$3,450,000
Interest on investments	500,000	350,000
	4,800,000	3,800,000
Interest expense		
Savings accounts	2,500,000	2,400,000
Borrowed funds	300,000	200,000
	2,800,000	2,600,000
Net interest income	2,000,000	1,200,000
Provision for loan losses (Note 3)	100,000	20,000
Net interest income after provision for loan losses	1,900,000	1,180,000
Operating expense		
General and administrative		
Compensation and benefits (Note 8)	700,000	580,000
Occupancy	200,000	150,000
Other	500,000	260,000
	1,400,000	990,000
Operating income	500,000	190,000
Other income (expense)		
Securities gains	70,000	250,000
Loss on sale of property and equipment	(20,000)	—
Net income	$550,000	$440,000

The accompanying notes are an integral part of these financial statements.

Sample Credit Union
Statement of Retained Earnings
Years Ended December 31, 19X2 and 19X1

	Appropriated			
	Statutory	*Other*	*Unappropriated*	*Total*
Balance, January 1, 19X1	$1,680,000	$500,000	$ 380,000	$2,560,000
Transfers, net	180,000	—	(180,000)	—
Net income	—	—	440,000	440,000
Balance, December 31, 19X1	1,860,000	500,000	640,000	3,000,000
Transfers, net	140,000	—	(140,000)	—
Net income	—	—	550,000	550,000
Balance, December 31, 19X2	$2,000,000	$500,000	$1,050,000	$3,550,000

The accompanying notes are an integral part of these financial statements.

Sample Credit Union

Statements of Changes in Financial Position *

Years Ended December 31, 19X2 and 19X1

	19X2	*19X1*
Funds Provided		
Operations		
Net income	$550,000	$440,000
Items not requiring the use of funds		
Members' earnings credited to savings accounts	2,000,000	2,000,000
Provision for loan losses	100,000	20,000
Depreciation and amortization	50,000	50,000
Funds provided by operations	2,700,000	2,510,000
Decrease in investments	2,000,000	1,000,000
New borrowed funds	4,000,000	2,000,000
Increase in accrued and other liabilities	300,000	200,000
Total funds provided	$9,000,000	$5,710,000
Funds Used		
Increase in loans to members	$4,000,000	$2,800,000
Decrease in savings accounts	1,860,000	1,850,000
Repayment on borrowed funds	3,000,000	1,000,000
Increase in property and equipment	200,000	100,000
Increase in accrued interest receivable and other assets	40,000	30,000
Total funds used	9,100,000	5,780,000
Decrease in cash	$100,000	$70,000

The accompanying notes are an integral part of these financial statements.

* [Note—FASB Statement No. 95, *Statement of Cash Flows,* as amended supersedes APB Opinion 19, *Reporting Changes in Financial Position,* and requires a statement of cash flows as part of a full set of financial statements for all business enterprises in place of a statement of changes in financial position. A statement of Cash Flows will be illustrated in future editions.]

Sample Credit Union

Notes to Financial Statements

December 31, 19X2 and 19X1

1. Significant Accounting Policies

Investments. Investment securities are stated at cost adjusted for amortization of premiums and accretion of discounts, which are recognized as adjustments to interest income on investments. Gains or losses on disposition are based on the net proceeds and the adjusted carrying amount of the securities sold, using the specific identification method.

Loans to members and allowance for loan losses. Loans are stated at the amount of unpaid principal, reduced by an allowance for loan losses. Interest on loans is recognized over the term of the loan and is calculated using the simple-interest method on principal amounts outstanding. The allowance for loan losses is established through a provision for loan losses charged to expenses. Loans are charged against the allowance for loan losses when management believes that the collectibility of the principal is unlikely. The allowance is an amount that management believes will be adequate to absorb possible losses on existing loans that may become uncollectible, based on evaluations of the collectibility of loans and prior loan loss experience. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans, and current economic conditions that may affect the borrowers' ability to pay. Accrual of interest is discontinued on a loan when management believes, after considering economics, business conditions, and collection efforts, that the borrowers' financial condition is such that collection of interest is doubtful.

Property and equipment. Property and equipment are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line method over the estimated useful lives of the assets.

Pension plan. The credit union has a noncontributory pension plan covering substantially all employees. The credit union's policy is to fund accrued pension costs. Prior service costs are being amortized over thirty years.

2. Investments

The carrying value and approximate market value of investments are as follows:

	December 31			
	19X2		*19X1*	
	Carrying Value	*Market Value*	*Carrying Value*	*Market Value*
U.S. government and agency obligations	$4,000,000	$3,000,000	$5,500,000	$5,000,000
Common trust funds	400,000	400,000	1,000,000	1,000,000
Time deposits	400,000	400,000	500,000	500,000
Loans to other credit unions	200,000	200,000	—	—
	$5,000,000	$4,000,000	$7,000,000	$6,500,000

3. Loans to Members

The composition of loans to members is as follows:

	December 31	
	19X2	*19X1*
Automobile	$22,500,000	$21,000,000
Mortgage	7,400,000	6,400,000
Unsecured	6,000,000	5,000,000
Lines of credit	5,700,000	4,800,000
Share secured loans	1,500,000	1,300,000
Education	1,000,000	1,700,000
Other	1,200,000	1,000,000
	45,300,000	41,200,000
Less		
Undisbursed portion of loans	300,000	200,000
Allowance for loan losses	200,000	100,000
	44,800,000	40,900,000

A summary of loans by maturity as of December 31, 19X2, is as follows:

Maturity within one year	$18,000,000
One to five years	19,500,000
Over five years	7,500,000
	$45,000,000

A summary of the changes in the allowance for loan losses is as follows:

	Year Ended December 31	
	19X2	*19X1*
Balance, beginning of year	$100,000	$70,000
Provision charged to operations	100,000	20,000
Loans charged off	(10,000)	(15,000)
Recoveries	10,000	25,000
Balance, end of year	$200,000	$100,000

Loans on which the accrual of interest has been discontinued or reduced amounted to $300,000 and $100,000 at December 31, 19X2 and 19X1, respectively. If interest on those loans had been accrued, such income would have approximated $10,100 and $4,600 for 19X2 and 19X1, respectively. Interest income on those loans, which is recorded only when received, amounted to $3,000 and $1,700 for 19X2 and 19X1, respectively.

4. Property and Equipment

Property and equipment is summarized as follows:

	December 31	
	19X2	*19X1*
Land	$ 100,000	$ 100,000
Building	650,000	650,000
Furniture and fixtures	200,000	150,000
Office equipment	300,000	150,000
	1,250,000	1,050,000
Accumulated depreciation	(200,000)	(150,000)
	$1,050,000	$ 900,000

Depreciation expense amounted to $50,000 in 19X2 and $50,000 in 19X1.

5. Savings Accounts

A summary of savings accounts is as follows:

	December 31	
	19X2	19X1
Share drafts	$3,500,000	$ 3,750,000
Regular savings	19,500,000	20,500,000
Money market accounts	12,500,000	10,000,000
Savings certificates	7,100,000	8,210,000
	$42,600,000	$42,460,000

A summary of savings accounts by maturity as of December 1, 19X2, is as follows:

No contractual maturity	$23,000,000
Maturity within one year	14,000,000
One to two years	3,000,000
Over two years	2,600,000
	$42,600,000

Dividend rates are set by the board of directors, based on an evaluation of current and future market conditions.

6. Borrowed Funds

Borrowed funds are as follows:

	December 31	
	19X2	19X1
Central Liquidity Facility, 15% due 19X3	$1,000,000	$—
Dollar Credit Union, 11% unsecured notes, due 19X3	2,250,000	—
First Trust Bank, 8.25-8.75% notes, due 19X2	—	1,500,000
Reverse repurchase agreements, 10%, secured by U.S. government obligations, due 19X3	750,000	—
ABC Co., 7.25-7.5%, due 19X2	—	500,000
Promissory notes, interest at 7.5%, due 19X3 and 19X2	1,000,000	2,000,000
	$5,000,000	$4,000,000

7. Retained Earnings

The Sample Credit Union is required by regulation to maintain a statutory reserve. This reserve, which represents a regulatory restriction of retained earnings, is not available for the payment of dividends.

Other appropriated retained earnings represent a restriction on the payment of dividends as established by the board of directors.

The Sample Credit Union is exempt, by statute, from federal and state income taxes.

8. Pension Plan

[Deleted—See FASB Statement No. 87, *Employers' Accounting for Pensions,* for current disclosure requirements.]

9. Commitments and Contingent Liabilities

Outstanding mortgage loan commitments at December 31, 19X2, total approximately $600,000. These commitments are not reflected in the financial statements.

The credit union is a party to various legal actions normally associated with financial institutions, the aggregate effect of which, in management's and legal counsel's opinion, would not be material to the financial condition of Sample Credit Union.

Appendix B

Consideration of the Internal Control Structure

The second standard of fieldwork is as follows:

> A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

The definition and characteristics of the basic concepts of internal control structure are discussed in SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit.*

This appendix presents a specific list of significant considerations relevant to the internal control structure in specific audit areas. It is not intended to be comprehensive.

Chapter 3. Cash

- Teller funds
  - Do tellers have exclusive access to, and custody of, their respective cash funds?
  - Is loss exposure reduced by limiting the amounts of tellers' funds?
  - Is a systematic plan used for surprise counts of tellers' cash funds?
  - Are tellers performing other accounting duties?
- Are physical storage facilities adequate to safeguard against loss?
- Is vault cash (reserve fund) under dual control?
- Is access to the night depository under the control of two employees, both of whom must be present when the safe's contents are removed, listed, and processed?
- Are cash items reviewed daily for propriety by a supervisory employee other than the custodian of the items?
- Are the functions of draft issuance, register maintenance, and reconciliation performed by different employees?
- Are bank reconciliations prepared on a periodic basis and properly approved?
- Are confirmation requests received from depository banks by an employee other than the one reconciling the account?

Chapter 4. Investment Securities

- Are security purchases, exchanges, and sales approved by the board of directors or by its designated committees or officials and recorded in the minutes?
- Does the board of directors receive regular reports on investment security activity showing such data as valuations, maturity analysis, and yields?
- Are accounting entries prepared by an employee not executing or authorizing security transactions?
- Are securities on hand kept under dual control?

- Are securities held by others verified periodically by physical examination, confirmation, or other procedures by persons independent of the employee responsible for control over the securities?
- Is the investment security subsidiary ledger balanced with reasonable frequency by an employee independent of the employee responsible for this ledger?
- Are investment securities on hand physically segregated from collateral securities and are they under physical control of individuals other than those controlling collateral securities?

Chapter 5. Loans

- Are loans granted in accordance with policies established by the board of directors and the credit committee?
- Are credit reports obtained for new loans?
- Are loans properly approved by officers and reviewed by the credit committee?
- Is the performance of the three functions—loan approval, disbursement and collection, and ledger posting—appropriately segregated among different employees?
- Is disbursement of loan proceeds to the borrower in cash, if permitted, properly documented?
- Is physical protection of notes, collateral, and supporting documents adequate?
- Are ledger trial balances prepared periodically and reconciled with control accounts by employees who do not process or record loan transactions?
- Are paid notes cancelled and returned to the borrowers?
- Are supporting documents on new loans inspected for proper form, completeness, and accuracy by someone other than the lending officer?
- Are loans reviewed on a timely basis for collectibility, write-offs recorded where applicable, and allowance for loan losses evaluated properly?
- Are loans receivable and related collateral accepted, modified, and released only if properly authorized?

Chapter 7. Other Assets

Property and Equipment

- Are transactions (additions, transfers, and disposals) properly authorized and recorded?
- Do balances represent physical property installed or constructed, and is the asset a proper capitalizable item?
- Are depreciation amounts provided in relation to the estimated life of the asset?
- Are leases properly recorded?

Assets Acquired in Liquidation of Loans

- Has a capitalization policy been established?
- Is there proper control over related expense and income?
- Is there a segregation of duties between lending personnel and personnel responsible for assets acquired?

- Are gains or losses on sales recorded properly and approved?

Insurance

- Is the credit union adequately insured for asset and fidelity bond losses?

Chapter 8. Savings Accounts

- Are subsidiary ledger control accounts periodically reconciled to the general ledger?
- Are controls sufficient for closed and dormant accounts?
- Are savings and loan account statements mailed to members periodically?
- Is segregation of duties adequate?
- Is there adequate protection and maintenance of files, ledger cards, cancelled share drafts, cash received vouchers, and signature cards?
- Are employees' accounts periodically reviewed for unusual transactions?
- Is disbursement of savings withdrawals to a member properly documented?

Chapter 9. Borrowed Funds

- Is there a clearly communicated policy on limits on amounts of borrowings by type and other liability management guides?
- Is there adequate segregation of duties so that the subsidiary records are not handled by personnel who also process receipts, make disbursements, or prepare all the supporting documents for debt repayment?
- Are subsidiary records reconciled at least monthly with general ledger control accounts?
- Are repaid notes returned to the credit union appropriately endorsed and cancelled?
- Are provisions of debt agreements complied with?
- Are interest computations independently checked?
- Are periodic reports to management made, showing all important borrowed funds activity?

Chapter 10. Other Liabilities

- Are purchases authorized and promptly and accurately recorded?
- Are supplies and services purchased for approved purposes at reasonable prices?
- Are subsidiary records reconciled periodically to general ledger control accounts?
- Is there adequate segregation of duties?
- Are payments properly authorized and recorded promptly and accurately?

Chapter 12. Operating Revenue and Expense

- Are income and expenses recorded in the proper accounting period?
- Are income and expenses classified to permit an accurate evaluation of operating results?
- Are prepared budgets compared with actual operating results and are explanations obtained for variances?
- Are payroll costs promptly and accurately recorded?
- Are payroll payments made in the correct amount to employees of the credit union for services actually performed?
- Are detailed and overall tests of loan income and dividend expense performed?

Appendix C

Statement of Position 90-5

Inquiries of Representatives of Financial Institution Regulatory Agencies

August 31, 1990

Amendment to
AICPA Industry Audit Guide
Audits of Banks,
AICPA Audit and Accounting Guide
Audits of Credit Unions

Prepared by the AICPA Committees on Banking,
Credit Unions, and Savings and Loan Associations

American Institute of
Certified Public Accountants

AICPA

NOTICE TO READERS

This Statement of Position presents the recommendations of the AICPA Committees on Banking, Credit Unions, and Savings and Loan Associations regarding the application of generally accepted auditing standards to audits of financial statements of banks, credit unions, and savings institutions. Members of the AICPA Auditing Standards Board have found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

Inquiries of Representatives of Financial Institution Regulatory Agencies

1. In the last few years, there have been several well-publicized incidents in which a financial institution, as a result of examinations by regulatory agencies, has been required to restate its financial statements on which an independent auditor had rendered an unqualified opinion dated during or subsequent to the period in which such examinations were being conducted.[1] These restatements have resulted from—

a. Differences in judgment between the examiners[2] and the financial institution's management regarding, for instance, the adequacy of the allowance for loan losses.

b. Information and judgments about matters, such as violations of laws or regulations, known to, or made by, the examiners but not known to management or the independent auditor.

2. The objective of this statement of position is to assure that the independent auditor considers regulatory examiners as a source of competent evidential matter in conducting an audit of a financial institution's financial statements.

3. Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards,* vol. 1, AU sec. 342.08) states that the auditor should consider evaluating "information contained in regulatory or examination reports, supervisory correspondence, and similar materials from applicable regulatory agencies." SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards,* vol. 1, AU sec. 317.09) notes that "the auditor may encounter specific information that may raise a question concerning possible illegal acts, such as . . . violations of laws or regulations cited in reports of examinations by regulatory agencies that have been made available to the auditor." Accordingly, it is appropriate that the independent auditor review reports of examination and related communications between examiners and the financial institution to obtain competent evidential matter.

4. Policies of the five federal[3] and most state agencies that regulate financial institutions have traditionally allowed an institution's independent auditor access to certain confidential reports of examinations of the institution. In addition, examiners generally have been permitted to provide pertinent information to the independent auditor with the prior approval of the financial institution. Further, examiners have permitted the independent auditor, with the permission of the financial institution, to attend, as an observer, the exit conference between examiners and the board of directors (or an appropriate board committee) or executive officers of the financial institution or both.

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[1] For purposes of this statement of position, the term *financial institution* includes banks, mutual and stock savings banks, savings and loan associations, bank and savings and loan holding companies, and credit unions.

[2] Examiners acting on behalf of regulators of financial institutions are those individuals responsible for supervising the performance or preparation of the reports of examination or both and, when appropriate, supervisory personnel at the district and national level.

[3] The five federal agencies are the Federal Deposit Insurance Corporation, the Federal Reserve Board, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. Under section 931 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, financial institutions are required to furnish to the independent auditor a copy of the most recent examination report, any supervisory memorandum of understanding with the financial institution, and any report of any action initiated or taken by federal or state financial institution regulatory agencies.

Conclusion

5. Chapter 2 ("Auditing Considerations") of the AICPA Industry Audit Guide *Audits of Banks,* and chapter 2 ("Auditing Considerations") of the AICPA Audit and Accounting Guide *Audits of Credit Unions* are amended to include the following:

Communications Between Independent Auditors and Examiners

The independent auditor should review reports of significant examinations and related communications between examiners and the financial institution and, when appropriate, make inquiries of the examiners. The independent auditor should—

- Request that management provide access to all reports of examinations and related correspondence.[4]
- Review reports of significant examinations and related correspondence between examiners and the financial institution during the period under audit through the date of the independent auditor's report.
- Communicate with the examiners, with the prior approval of the financial institution, when their examination of the financial institution is in process or a report on an examination has not been received by the financial institution.

A refusai by management to allow the independent auditor to review communications from, or to communicate with, the examiner would ordinarily be a limitation on the scope of the audit sufficient to preclude an opinion (see AICPA, *Professional Standards,* vol. 1, AU secs. 508.40 through 508.44). A refusal by the examiner to communicate with the auditor may be a limitation on the scope of the audit sufficient to preclude an unqualified opinion, depending on the auditor's assessment of other relevant facts and circumstances.

In addition, the independent auditor should consider attending, as an observer, with the prior approval of the financial institution, the exit conference between the examiner and the financial institution's board of directors (or an appropriate board committee) or its executive officers or both. Also, if the examiners request permission to attend the meeting between the independent auditor and management or the financial institution's board of directors (or an appropriate board committee) or both to review the report on the audit of the financial statements, and management concurs, the independent auditor should endeavor to be responsive to that request.

Effective Date

The conclusions in this statement of position should apply to audits of financial statements for periods ending on or after September 30, 1990.

[4] Examinations of financial institutions either can be general in nature and comprehend capital adequacy, quality of loans, investments and other assets, and the financial institution's ability to manage liquidity and funding, or they can be targeted to a specific area of the financial institution's operations, such as real-estate lending or trust operations. In addition, examinations may be limited to compliance with laws and regulations applicable to the financial institution—for example, the Bank Secrecy Act, Consumer Protection, Insider Transactions, Municipal Securities Rule Making Board Requirements, or Regulatory Reporting.

Appendix D

Statement of Position 90-11

Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets

November 30, 1990

Amendment to
AICPA Audit and Accounting Guides
Audits of Banks,
Audits of Credit Unions,
Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies),
Audits of Property and Liability Insurance Companies, and
Audits of Stock Life Insurance Companies

Issued by the
Accounting Standards Executive Committee

American Institute of
Certified Public Accountants

AICPA

NOTICE TO READERS

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity with Generally Accepted Accounting Principles *in the Independent Auditor's Report,* identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets

Scope

1. This statement of position provides guidance for disclosure by financial institutions of certain information about debt securities held as assets. It applies to financial institutions whose policy is to carry such securities either at historical cost or at the lower of cost or market value. Such financial institutions include banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance companies. Entities other than financial institutions that include financial institution subsidiaries in their consolidated financial statements should provide the disclosures required by this statement for debt securities held as assets by such subsidiaries.

2. As used in this statement, *debt securities* include—

- Bills, notes, and bonds issued by—
  - *a.* The federal, state, and local governments in the United States and agencies and authorities of those governments.
  - *b.* Foreign governments and agencies of those foreign governments.
- Bonds and commercial paper issued by business enterprises and not-for-profit organizations, including collateralized bond obligations and interest-only and principal-only strips of such bonds and commercial paper.
- Mortgage-backed and other securitized debt instruments, including collateralized mortgage obligations[1] and principal-only and interest-only strips of such instruments.

Debt securities also include preferred stock that, by its terms, either must be redeemed by the issuing enterprise or is redeemable at the option of the investor because, for the purposes of this statement, such preferred stock has the essential characteristics of debt. Other unsecuritized commercial and personal loans; notes and bonds of foreign governments classified as loans; and unsecuritized leases, credit card receivables, real estate loans, construction loans, and automobile loans are not included in the scope of this statement.

3. This statement amends the following AICPA industry audit and accounting guides:

- *Audits of Banks*
- *Audits of Credit Unions*
- *Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies)*
- *Audits of Property and Liability Insurance Companies*
- *Audits of Stock Life Insurance Companies*

[1] For purposes of this statement, collateralized mortgage obligations also include instruments issued in equity form that are required to be accounted for as nonequity instruments under the consensus on Emerging Issues Task Force Issue 89-4.

Background

4. On May 25, 1990, the Accounting Standards Executive Committee (AcSEC) issued an exposure draft of a proposed statement of position, *Reporting by Financial Institutions of Debt Securities Held as Assets.* That exposure draft was issued in response to concerns that the guidance on reporting debt securities held as assets in the AICPA audit and accounting guides for the various financial industries is uniform for particular industries but is inconsistent from industry to industry. Further, changes in the economic environment, deregulation of interest rates, the increased sophistication of interest rate and other risk management techniques, and the availability of new financial instruments used to reduce or hedge interest rate risk have resulted in increased purchases and sales of debt securities classified as investments, which have contributed to diversity in the application of that guidance.

5. Regulators of financial institutions have expressed concern about certain activities concerning securities classified as investments. Such activities are described in the April 14, 1988, Banking Circular, *Selection of Securities Dealers and Unsuitable Investment Practices,* which is reproduced in Appendix B.

6. The exposure draft recommended guidance on reporting debt securities held as investment assets that attempted to make more workable the assessment of the ability and intent to hold such securities that is required under current literature. However, comment letters on the exposure draft raised significant questions about the subjectivity of the guidance, and AcSEC concluded that the proposal needed to be studied further.

7. The exposure draft proposed disclosures about debt securities held as assets, and many commentators recommended expanded disclosures as an interim solution. This statement is intended to be such an interim solution.

Conclusions

8. Financial institutions should include in the notes to their financial statements an explanation of their accounting policies for debt securities held, including the basis for classification into balance sheet captions, such as investment or trading.

9. Financial institutions should also disclose in the notes to their financial statements the following information concerning debt securities carried at either historical cost or the lower of cost or market value[2]:

- For each balance sheet presented, the amortized cost [3], estimated market values, gross unrealized gains, and gross unrealized losses for each pertinent category. Examples of such categories are the following:
  - — Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies
  - — Debt securities issued by states of the U.S. and political subdivisions of the states

[2] If a financial institution carries some debt securities at amortized cost and others at the lower of cost or market value and it reports them in separate balance sheet captions, these disclosures should be presented for each caption.

[3] Amortized cost is the face amount of the debt security increased or decreased by unamortized premium, discount, finance charges, or acquisition fees and costs and may also reflect a previous direct write-down of the debt security. Total amortized cost presented in this disclosure should be reconciled to the amounts presented in the balance sheet, if different.

- — Debt securities issued by foreign governments and not classified as loans
- — Corporate securities
- — Mortgage-backed securities
- — Other debt securities

- For the most recent balance sheet, the amortized cost and estimated market values of debt securities due—
  a. In one year or less
  b. After one year through five years
  c. After five years through ten years
  d. After ten years[4]
- For each period for which results of operations are presented, the proceeds from sales[5] of such debt securities and gross realized gains and gross realized losses on such sales

Effective Date and Transition

10. This statement is effective for financial statements for fiscal years ending after December 15, 1990. This statement need not be applied to financial statements for fiscal years ending before its effective date that, for comparative purposes, are being provided with financial statements for fiscal years ending after its effective date.

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[4] Securities not due at a single maturity date, such as mortgage-backed securities, may be included in a separate category. If such securities are not included in a separate category, the method used for inclusion in the maturity table should be disclosed.

[5] As debt securities approach maturity, their market prices tend to approach their maturity amounts less interest and a factor for credit risk, and market risk diminishes as a factor in their pricing. For purposes of this statement, securities that are sold at maturity or near enough to maturity that market risk is substantially eliminated as a pricing factor may be excluded from this disclosure.

APPENDIX A

Illustrative Financial Statement Disclosure

Investment Securities

The amortized cost and estimated market values of investments in debt securities are as follows: [a]

	Amortized Cost [b]	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$XXXXX	$XXX	$(XXX)	$ XXXXX
Obligations of states and political subdivisions	XXXXX	XXX	(XXX)	XXXXX
Debt securities issued by foreign governments	XXXXX	XXX	(XXX)	XXXXX
Corporate securities	XXXXX	XXX	(XXX)	XXXXX
Mortgage-backed securities	XXXXX	XXX	(XXX)	XXXXX
Other debt securities	XXXXX	XXX	(XXX)	XXXXX
Totals	$XXXXX	$XXX	$(XXX)	$ XXXXX

The amortized cost and estimated market value of debt securities at December 31, 19XX, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

[a] This information should be provided for each balance sheet presented that is dated after December 15, 1990.

[b] See footnote 3.

	Amortized Cost	Estimated Market Value
Due in one year or less	$ XXX	$ XXX
Due after one year through five years	XXX	XXX
Due after five years through ten years	XXX	XXX
Due after ten years	XXX	XXX
	XXXX	XXXX
Mortgage-backed securities	XXX	XXX
	$XXXXX	$XXXXX

Proceeds from sales of investments in debt securities during 19XX were $______. Gross gains of $______ and gross losses of $______ were realized on those sales.[c]

[c] This information should be provided for each period for which results of operations are presented for periods ending after December 15, 1990.

APPENDIX B

BANKING CIRCULAR—SELECTION OF SECURITIES DEALERS AND UNSUITABLE INVESTMENT PRACTICES *

PURPOSE

This issuance is to provide you with recommended procedures to be employed by all national banks when selecting securities dealers and to advise you of certain securities activities that the depository institution regulators view as unsuitable in an investment portfolio. The Federal Financial Institution Examination Council (FFIEC) recently endorsed the same policy statement. Adoption of the FFIEC policy is intended to achieve uniform and effective supervision by depository institution investment portfolio managers. The following is the text of the policy statement.

BACKGROUND

The depository institution regulators have become aware of speculative activity which has taken place in a number of depository institutions' investment portfolios. Certain of these institutions have failed because of the speculative activities, and other institutions have been weakened significantly as their earnings and capital have been impaired and the liquidity of their securities has been eroded by the depreciation in their market value.

Speculative activity often occurs when a depository institution's investment portfolio manager follows the advice of securities dealers who, in order to generate commission income, encourage speculative practices that are unsuitable for the investment portfolio.

RECOMMENDATIONS CONCERNING THE SELECTION OF A SECURITIES DEALER

It is common for the investment portfolio managers of many depository institutions to rely on the expertise and advice of a securities sales representative for: recommendations of proposed investments; investment strategies; and the timing and pricing of securities transactions. Accordingly, it is important for the management of depository institutions to know the securities firms and the personnel with whom they deal. An investment portfolio manager should not engage in securities transactions with any securities dealer that is unwilling to provide complete and timely disclosure of its financial condition. Management must review the dealer's financial statements and make a judgment about the ability of the dealer to honor its commitments. An inquiry into the general reputation of the dealer also is necessary.

The board of directors and/or an appropriate board committee should review and approve a list of securities firms with whom the depository's management is authorized to do business. The following securities dealer selection standards are recommended, but are not all inclusive. The dealer selection process should include:

- a consideration of the ability of the securities dealer and its subsidiaries or affiliates to fulfill commitments as evidenced by capital strength and operating results disclosed in current financial data, annual reports, credit reports, etc.;

* This banking circular was distributed by the comptroller of the currency on April 14, 1988, to chief executive officers of all national banks, deputy comptrollers, and all examining personnel.

- an inquiry into the dealer's general reputation for financial stability and fair and honest dealings with customers, including an inquiry of past or current financial institution customers of the securities dealer;
- an inquiry of appropriate State or Federal securities regulators and securities industry self-regulatory organizations, such as the National Association of Securities Dealers, concerning any formal enforcement actions against the dealer or its affiliates or associated personnel;
- an inquiry, as appropriate, into the background of the sales representative to determine his or her experience and expertise;
- a determination whether the depository institution has appropriate procedures to establish possession or control of securities purchased. Purchased securities and repurchase agreement collateral should only be kept in safekeeping with selling dealers when (1) the board is completely satisfied as to the creditworthiness of the securities dealer and (2) the aggregate value of securities held in safekeeping in this manner is within credit limitations that have been approved by the board of directors, or a committee of the board, for unsecured transactions (see FFIEC Policy Statement adopted October 1985). Federal credit unions, when entering into a repurchase agreement with a broker/dealer, are not permitted to maintain the collateral with the broker/dealer, reference part 703 of the National Credit Union Administration rules and regulations.

As part of the process of managing a depository institution's relationships with securities dealers the board of directors may wish to consider including in the financial institution's code of ethics or code of conduct a prohibition by those employees, who are directly involved in purchasing and selling securities for the depository institution, from engaging in personal securities transactions with the same securities firm that the depository institution uses for its transactions without specific board approval and periodic review. The board also may wish to adopt a policy applicable to directors, officers or employees concerning the receipt of gifts, gratuities or travel expenses from approved dealer firms and their personnel (also see in this connection the Bank Bribery Law, 18 USC 215 and interpretive releases).

OBJECTIONABLE INVESTMENT PRACTICES

Depository institution directors are responsible for prudent administration of investments in securities. An investment portfolio traditionally has been maintained by a depository institution to provide earnings, liquidity and a means of diversifying risks. When investment transactions are entered into in anticipation of taking gains on short-term price movements, the transactions are no longer characteristic of investment activities and should be conducted in a securities trading account. Securities trading of the types described in section I of the attached appendix will be viewed as unsuitable activities when they are conducted in a depository institution's investment account. Securities trading should take place only in a closely supervised trading account and be undertaken only by institutions that have strong capital and current earnings positions. Acquisitions of the various forms of zero coupon, stripped obligations and asset-backed securities residuals discussed in section II of the attached appendix will receive increased regulatory attention and, depending upon the circumstances, may be considered unsuitable for a depository institution.

State chartered financial institutions are cautioned that certain of the investment practices listed in the appendix may violate state law. If any such practices are contemplated, the appropriate state supervisor should be consulted regarding permissibility under state law.

Appendix to FFIEC Supervisory Policy Statement on the Selection of Securities Dealers and Unsuitable Investment Practices

I. TRADING IN THE INVESTMENT PORTFOLIO

Trading in the investment portfolio is characterized by a high volume of purchase and sale activity, which when considered in light of a short holding period for securities, clearly demonstrates management's intent to profit from short-term price movements. In this situation, a failure to follow accounting and reporting standards applicable to trading accounts may result in a misstatement of the depository institution's income and a filing of false regulatory reports and other published financial data. It is an unsafe and unsound practice to record and report holdings of securities that result from trading transactions using accounting standards which are intended for investment portfolio transactions; therefore, the discipline associated with accounting standards applicable to trading accounts is necessary. Securities held in trading accounts should be marked to market, or the lower of cost or market, periodically with unrealized gains or losses recognized in current income. Prices used in periodic revaluations should be obtained from sources that are independent of the securities dealer doing business with the depository.

The following practices are considered to be unsuitable when they occur in a depository institution's investment portfolio.

A. "Gains Trading". "Gains trading" is a securities trading activity conducted in an investment portfolio, often termed "active portfolio management." "Gains trading" is characterized by the purchase of a security as an investment and the subsequent sale of that same security at a profit within several days or weeks. Those securities initially purchased with the intent to resell are retained as investment portfolio assets if they cannot be sold at a profit. These "losers" are retained in the investment portfolio because investment portfolio holdings are accounted for at cost, and losses are not recognized unless the security is sold. "Gains trading" often results in a portfolio of securities with extended maturities, lower credit quality, high market depreciation and limited practical liquidity.

In many cases, "gains trading" has involved the trading of "when-issued" securities and "pair-offs" or "corporate settlements" because the extended settlement period associated with these practices allows speculators the opportunity for substantial price changes to occur before payment for the securities is due.

B. "When-Issued" Securities Trading. "When-issued" securities trading is the buying and selling of securities in the interim between the announcement of an offering and the issuance and payment date of these securities. A purchaser of a "when-issued" security acquires all the risks and rewards of owning a security and may sell the "when-issued" security at a profit before taking delivery and paying for it. Frequent purchases and sales of securities during the "when-issued" period generally are indications of trading activity and should not be conducted in a bank's investment portfolio.

C. "Pair-Offs". A "pair-off" is a security purchase transaction which is closed out or sold at, or prior to, settlement date. As an example, an investment portfolio manager will commit to purchase a security; then, prior to the predetermined settlement date, the portfolio manager will "pair-off" the purchase with a sale of the same security prior to, or on, the original settlement date. Profits or losses on the transaction are settled by one party to the transaction remitting to the counter party the difference between the purchase and sale price. Like "when-issued" trading, "pair-offs" permit speculation on securities price movements without paying for the securities.

D. Corporate Settlement on U.S. Government and Federal Agency Securities Purchases. Regular-way settlement for transactions in U.S. Government and Federal agency securities is one business day after the trade date. Regular-way settlement for corporate securities is five business days after the trade date. The use of a corporate settlement method (5 business days) for U.S. Government securities purchases appears to be offered by dealers in order to facilitate speculation on the part of the purchaser.

E. Repositioning Repurchase Agreements. Dealers who encourage speculation through the use of "pair-off," "when-issued" and "corporate settlement" transactions often provide the financing at settlement of purchased securities which cannot be sold at a profit. The buyer purchasing the security pays the dealer a small "margin" that is equivalent roughly to the actual loss in the security. The dealer then agrees to fund the purchase by buying the security back from the purchaser under a resale agreement. Apart from imprudently funding a longer-term, fixed-rate asset with short-term, variable-rate source funds, the purchaser acquires all the risks of ownership of a large amount of depreciated securities for a very small margin payment. Purchasing securities in these circumstances is inherently speculative and is a wholly unsuitable investment practice for depository institutions.

F. Short Sales. A short sale is the sale of a security that is not owned. The purpose of a short sale generally is to speculate on the fall in the price of the security. Short sales are speculative transactions that should be conducted in a trading account, and when conducted in the investment portfolio, they are considered to be unsuitable.

Short sales are not permissible activities for Federal credit unions.

II. STRIPPED MORTGAGE-BACKED SECURITIES, RESIDUALS, AND ZERO COUPON BONDS

There are advantages and disadvantages in owning these products. A depository institution must consider the liquidity, marketability, pledgeability, and price volatility of each of these products prior to investing in them. It may be unsuitable for a depository institution to commit significant amounts of funds to long-term stripped mortgage-backed securities, residuals and zero coupon bonds which fluctuate greatly in price.

A. Stripped Mortgage-Backed Securities (SMBS) consist of two classes of securities with each class receiving a different portion of the monthly interest and principal cash flows from the underlying mortgage-backed securities. In its purest form, an SMBS is converted into an interest-only (IO) strip, where the investor receives 100% of the interest cash flows, and a principal-only (PO) strip, where the investor receives 100% of the principal cash flows.

All IOs and POs have highly volatile price characteristics based, in part, on the prepayment of the underlying mortgages and consequently on the maturity of the stripped security. Generally, POs will increase in value when interest rates decline while IOs increase in value when interest rates rise. Accordingly, the purchase of an IO strip may serve, theoretically, to offset the interest rate risk associated with mortgages and similar instruments held by a depository institution. Similarly, a PO may be useful as an offset to the effect of interest rate movements on the value of mortgage servicing. However, when purchasing an IO or PO the investor is speculating on the movements of future interest rates and how these movements will affect the prepayment of the underlying collateral. Furthermore, those SMBS that do not have the guarantee of a government agency or a government-sponsored agency as to the payment of principal and interest have an added element of credit risk.

As a general rule, SMBS cannot be considered as suitable investments for the vast majority of depository institutions. SMBS, however, may be appropriate holdings for depository institutions that have highly sophisticated and well-managed securities portfolios, mortgage portfolios or mortgage banking functions. In such depository institutions, however, the acquisition of SMBS should be undertaken only in conformance with carefully developed and documented plans prescribing specific positioning limits and control arrangements for enforcing these limits. These plans should be approved by the institution's board of directors and vigorously enforced.

In those depository institutions that prepare their published financial statements in accordance with Generally Accepted Accounting Principles, SMBS holdings must be accounted for in accordance with Financial Accounting Standards Board Statement No. 91 (FAS No. 91) which requires that the carrying amount be adjusted when actual prepayment experience differs from prepayment estimates. Other institutions may account for their SMBS holdings under FAS No. 91 or alternatively at market value or the lower of cost or market value.

Several states have adopted, or are considering, regulations that prohibit state chartered banks from purchasing IO strips. Accordingly, state chartered institutions should consult with their state regulator concerning the permissibility of purchasing SMBS.

B. Asset-Backed Securities (ABS) Residuals. Residuals are the excess cashflows from an ABS transaction after the payments due to the bondholders and the trust administrative expenses have been satisfied. This cashflow is extremely sensitive to prepayments, and thus has a high degree of interest rate risk.

Generally, the value of residual interests in ABS rises when interest rates rise. Theoretically a residual can be used as a risk management tool to offset declines in the value of fixed-rate mortgage or ABS portfolios. However, it should be understood by all residual interest purchasers that the "yield" on these instruments is inversely related to their effectiveness as a risk management vehicle. In other words, the highest yielding ABS residuals have limited risk management value usually due to a complicated ABS structure and/or unusual collateral characteristics that make modeling and understanding the economic cashflows very difficult.

Alternatively, those residuals priced for modest yields generally have positive risk management characteristics.

In conclusion, it is important to understand that a residual cashflow is highly dependent upon the prepayments received. Caution should be exercised when purchasing a residual interest, especially higher "yielding" interests, because the risk associated over the life of the ABS may warrant an even higher return in order to adequately compensate the investor for the interest rate risk assumed. Purchases of these equity interests should be supported by in-house evaluations of possible rate of return ranges in combination with varying prepayment assumptions.

Residual interests in ABS are not permissible acquisitions for Federal credit unions. Holdings of ABS residuals by other institutions should be accounted for in the manner discussed under stripped mortgage-backed securities and should be reported as "Other Assets" on regulatory reports.

C. Other Zero Coupon or Stripped Products. The interest and/or principal portions of U.S. Government obligations are sometimes sold to depository institutions in the form of stripped coupons, stripped bonds (principal), STRIPS, or propriety products, such as CATs or TIGRs. Also, Original Issue Discount Bonds (OIDs) have been issued by a number of municipal entities. Longer maturities of these instruments can exhibit extreme price volatility and, accordingly, disproportionately large long-maturity holdings (in relation to the total portfolio) of zero coupon securities appear to be unsuitable for investment holdings for depository institutions.

Appendix E

Statement of Position 92-3

Accounting for Foreclosed Assets

April 28, 1992

Issued by the
Accounting Standards Division

American Institute of
Certified Public Accountants

AICPA

NOTICE TO READERS

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report,* identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

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SUMMARY

This statement of position (SOP) provides guidance on measuring foreclosed assets and in-substance foreclosed assets after foreclosure. It applies to all reporting entities, except those that account for assets at fair value or market value. It applies to all assets obtained through foreclosure or repossession, except for inventories, marketable equity securities, and real estate previously owned by the lender and accounted for under FASB Statement of Financial Accounting Standards No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects.*

Under the SOP, there is a rebuttable presumption that foreclosed assets are held for sale. The SOP recommends that foreclosed assets held for sale be carried at the lower of (*a*) fair value minus estimated costs to sell or (*b*) cost. Foreclosed assets held for the production of income should be treated the same way they would be had the assets been acquired in a manner other than through foreclosure.

The SOP should be applied to foreclosed assets in annual financial statements for periods ending on or after December 15, 1992.

Accounting for Foreclosed Assets

Scope

1. This statement of position (SOP) provides guidance on determining the balance sheet treatment of foreclosed assets [1] after foreclosure. (Paragraphs A-6 and A-7 of the Appendix discuss the exclusion from this SOP of conclusions on the accounting treatment of results of operations related to foreclosed assets held for sale.) It applies to all reporting entities except those that account for assets at market value or fair value, such as broker-dealers, futures commission merchants, and investment companies. It applies to all assets obtained through foreclosure or repossession except for *(a)* inventories that are covered by chapter 4 of Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins; (b)* marketable equity securities that are covered by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (Statement) No. 12, *Accounting for Certain Marketable Securities;* and *(c)* foreclosed real estate previously owned by the lender and accounted for under FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects.* Except for the requirements in paragraphs 12 and 17, the conclusions of this SOP do not apply to in-substance foreclosed assets (see paragraph A-10 of the Appendix).

Background

2. Paragraph 29 of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* issued in 1977, requires the following: "After a troubled debt restructuring, a creditor shall account for assets received in satisfaction of a receivable the same as if the assets had been acquired for cash." That requirement has been interpreted in diverse ways.

3. The American Institute of Certified Public Accountants' (AICPA's) Industry Audit Guide *Audits of Stock Life Insurance Companies* requires that foreclosed real estate be carried at the lower of cost (less accumulated depreciation) or market value, net of any encumbrances. Paragraphs 17 and 21 of SOP 75-2, *Accounting Practices of Real Estate Investment Trusts* (as amended by SOP 78-2), require that estimated losses on individual loans and properties be based on net realizable value. The guidance in the AICPA Audit and Accounting Guide *Audits of Savings Institutions* and in the Industry Audit Guide *Audits of Finance Companies* are consistent with SOPs 75-2 and 78-2. The AICPA Industry Audit Guide *Audits of Banks* states that subsequent to foreclosure, a loss on foreclosed real estate should be recognized if cost cannot be recovered through sale or use, but it does not indicate how the loss is to be measured. The AICPA Audit and Accounting Guides *Audits of Credit Unions* and *Audits of Property and Liability Insurance Companies* do not address accounting for foreclosed assets.

4. In practice, accounting by creditors for foreclosed assets, particularly real estate assets, is diverse. After foreclosure, some enterprises continue to write down the carrying amount of foreclosed assets for subsequent, further declines in fair value; others do not. After foreclosure, some enterprises discount projected cash flows related to foreclosed assets in estimating net realizable value of those assets; others do not.

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[1] As used in this SOP, the term *foreclosed assets* includes all assets received in satisfaction of a receivable in a troubled debt restructuring, as the term is used in FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings.* It includes real property and personal property; equity interests in corporations, partnerships, and joint ventures; and beneficial interests in trusts.

5. Sections 4(b)(1) and 4(b)(2)(A) of the Home Owners' Loan Act of 1933 as amended by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 generally provide that the director of the Office of Thrift Supervision prescribe uniform accounting and disclosure standards for savings associations, to be used in determining associations' compliance with applicable regulations, and incorporate generally accepted accounting principles into those standards to the same degree that such principles are used to determine compliance with regulations prescribed by federal banking agencies. Section 1215 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 also provides the following:

> Before the end of the 1-year period beginning on the date of the enactment of this Act [August 9, 1989], each appropriate Federal banking agency (as defined in section 3(q) of the Federal Deposit Insurance Act) shall establish uniform accounting standards to be used for determining the capital ratios of all federally insured depository institutions and for other regulatory purposes. Each such agency shall report annually to the Chairman and ranking minority member of the Committee on Banking, Housing, and Urban Affairs of the Senate and the Chairman and ranking minority member of the Committee on Banking, Finance and Urban Affairs of the House of Representatives any differences between the capital standards used by such agency and capital standards used by any other such agency. Each such report shall contain an explanation of the reasons for any discrepancy in such capital standards, and shall be published in the Federal Register.

6. The chairman of the Federal Home Loan Bank Board (now the Office of Thrift Supervision) asked the AICPA in 1987 to address the inconsistency between banks and savings and loan associations in accounting for loans and real estate assets. The AICPA's Accounting Standards Executive Committee (AcSEC) attempted to eliminate that inconsistency in 1988 and 1989 but decided to refer the matter to the FASB at that time. On April 4, 1989, soon after AcSEC's decision to refer the matter to the FASB, the chairman of the Federal Home Loan Bank Board wrote to the chairman of the Securities and Exchange Commission (SEC) asking that the SEC or its staff remove the inconsistency for public reporting entities. The SEC has not done so.

7. Further, the chairman of the Federal Deposit Insurance Corporation, in a letter to the FASB dated November 8, 1989, asked the FASB to assist in developing "uniform accounting standards among depository institutions." In that letter, the chairman stated that "the accounting treatment in practice for certain transactions among participants in the financial services industry seems to be more a reflection of the type of charter than the substance of the transaction." Furthermore, the chairman "urge[d] the FASB to reconcile the different accounting practices outlined in [AICPA] guides for thrifts, banks, and finance companies." In early 1990, AcSEC decided that it could deal with the inconsistencies and diversity in accounting for foreclosed assets, and this SOP is a result of that decision.

8. AcSEC believes that all enterprises, not just financial institutions, should account for foreclosed assets held for sale the same way, except that enterprises that account for assets at market value or fair value should not change their accounting. AcSEC's primary objectives in issuing this statement of position are to reduce the inconsistencies and diversity in accounting for foreclosed assets and to improve the understandability, comparability, and relevance of amounts reported as foreclosed assets in balance sheets. Another objective is to make all of the AICPA Audit and Accounting Guides and SOPs consistent on this matter. Achieving those objectives will also address the needs of Congress and the thrift and banking regulators.

9. This SOP affects the following AICPA statements of position and industry audit and accounting guides:

a. SOP 75-2, *Accounting Practices of Real Estate Investment Trusts,* paragraphs 15-23, 25, 27, 28, 29*a*, 29*b*, and 29*c*

b. SOP 78-2, *Accounting Practices of Real Estate Investment Trusts,* paragraph 6

c. *Audits of Banks*

d. *Audits of Savings Institutions*

e. *Audits of Finance Companies*

f. *Audits of Credit Unions*

g. *Audits of Property and Liability Insurance Companies*

h. *Audits of Stock Life Insurance Companies*

i. *Guide for the Use of Real Estate Appraisal Information*

Conclusions

Held-for-Sale Presumption

10. Most enterprises do not intend to hold foreclosed assets for the production of income but intend to sell them; in fact, some laws and regulations applicable to financial institutions require the sale of foreclosed assets. Therefore, under this SOP, it is presumed that foreclosed assets are held for sale and not for the production of income. That presumption may be rebutted, except for in-substance foreclosed assets, by a preponderance of the evidence. If the held-for-sale presumption is not rebutted, the asset should be classified in the balance sheet as held for sale.

11. The presumption of sale can be rebutted if (*a*) management intends to hold a foreclosed asset for the production of income, (*b*) that intent is not inconsistent with the enterprise's ability to do so or with laws or regulations, including the manner in which the laws or regulations are administered by federal or state regulatory agencies, and (*c*) that intent is supported by a preponderance of the evidence.

Foreclosed Assets Held for Sale

12. After foreclosure, foreclosed assets held for sale should be carried at the lower of (*a*) fair value[2] minus estimated costs to sell or (*b*) cost.[3] Such

[2] *Fair value,* as used in this SOP, is defined in paragraph 13 of FASB Statement No. 15 as follows:

> The fair value of the assets transferred is the amount that the . . . [creditor] could reasonably expect to receive for them in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value of assets shall be measured by their market value if an active market for them exists. If no active market exists for the assets transferred but exists for similar assets, the selling prices in that market may be helpful in estimating the fair value of the assets transferred. If no market price is available, a forecast of expected cash flows may aid in estimating the fair value of assets transferred, provided the *expected cash flows are* discounted at a rate commensurate with the risk involved.[6]
>
> [6] Some factors that may be relevant in estimating the fair value of various kinds of assets are described in paragraphs 88 and 89 of *APB* [Accounting Principles Board] *Opinion No. 16* ["Business Combinations"], paragraphs 12-14 of *APB Opinion No. 21,* "Interest on Receivables and Payables," and paragraph 25 of *APB Opinion No. 29,* "Accounting for Nonmonetary Transactions."

[3] The *cost* of such assets at the time of foreclosure is the fair value of the asset foreclosed or repossessed. Any specific valuation allowance related to the loan should not be carried forward. This SOP provides no guidance for determining cost subsequent to foreclosure (see paragraphs A-6 and A-7 of the Appendix).

determination should be made on an individual asset basis. If the fair value of the asset minus the estimated costs to sell the asset is less than the cost of the asset, the deficiency should be recognized as a valuation allowance. If the fair value of the asset minus the estimated costs to sell the asset subsequently increases and the fair value of the asset minus the estimated costs to sell the asset is more than its carrying amount, the valuation allowance should be reduced, but not below zero. Increases or decreases in the valuation allowance should be charged or credited to income.[4]

13. The amount of any senior debt (principal and accrued interest) to which the asset is subject should be reported as a liability at the time of foreclosure and not be deducted from the carrying amount of the asset; payments on such debt should be charged to the liability. Interest that accrues after foreclosure should be recognized as interest expense.

14. FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects,* was extracted by the FASB from SOP 78-3, *Accounting for Costs to Sell and Rent, and Initial Rental Operations of Real Estate Projects;* SOP 80-3, *Accounting for Real Estate Acquisition, Development, and Construction Costs,* and the AICPA Industry Audit Guide *Accounting for Retail Land Sales.* These documents did not, in the opinion of AcSEC, apply to foreclosed real estate held for sale. AcSEC therefore believes that the fair-value test in this SOP, not the net-realizable-value test in FASB Statement No. 67, should be applied to foreclosed real estate held for sale, except when the foreclosed real estate was previously owned by the lender and accounted for under FASB Statement No. 67, in which case such foreclosed assets should be accounted for under FASB Statement No. 67.

Foreclosed Assets Held for the Production of Income

15. After foreclosure, assets determined to be held for the production of income (and not held for sale) should be reported and accounted for in the same way that they would be had the assets been acquired other than through foreclosure.

Change in Classification

16. If it is subsequently decided that a foreclosed asset classified as held for sale will be held for the production of income, the asset should be reclassified from the held-for-sale category. The reclassification should be made at the amount the asset's carrying amount would have been had the asset been held for the production of income since the time of foreclosure. Selling costs included in the valuation allowance should be reversed. The net effect should be reported in income from continuing operations in the period in which the decision not to sell the asset is made.

Effective Date and Transition

17. This SOP should be applied to foreclosed assets in annual financial statements for periods ending on or after December 15, 1992, with earlier application permitted. On initial application of this SOP, all enterprises should adjust the carrying amount of foreclosed assets held for sale to the lower of *(a)* the fair value of the asset minus the estimated costs to sell the asset or *(b)* the cost of the asset as of the date of the initial adoption of this SOP. For many enterprises, adoption of this SOP will result in a change in accounting princi-

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[4] Because the allowance is considered a valuation adjustment, insurance enterprises should report changes in the valuation allowance as realized gains and losses in income, not as unrealized gains and losses in equity.

ple. The nature of the change should be disclosed in the financial statements of the period in which the change is made. Any adjustment arising from the initial application of this SOP should be included in income from continuing operations in the period in which the change is made. No restatement of previously issued financial statements or cumulative-effect adjustment as of the beginning of the year this SOP is first applied is permitted.

APPENDIX

Discussion of Major Comments on the Exposure Draft

A-1. This Appendix summarizes considerations that were deemed significant by members of AcSEC in reaching the conclusions in this SOP.

A-2. In the exposure draft, AcSEC concluded that there is a rebuttable presumption that foreclosed assets are held for sale and that foreclosed assets held for sale should be carried at the lower of cost or fair value minus the estimated costs to sell. Few respondents objected to those conclusions.

Held-for-Sale Presumption

A-3. Some respondents requested more explanation of the circumstances under which the held-for-sale presumption could be rebutted. After considering the concerns expressed by respondents about the rebuttable presumption, AcSEC decided not to give detailed, specific guidance, thereby allowing for the exercise of judgment in determining whether the presumption is rebutted by the facts in particular circumstances.

A-4. AcSEC recognizes that some enterprises may hold foreclosed assets for several years before sale and may even operate the assets, but concludes that a holding period in excess of one year does not, in and of itself, rebut the held-for-sale presumption. Further, AcSEC notes that if the form of the foreclosed asset is a majority interest in an enterprise, FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries,* requires the subsidiary to be consolidated unless control is likely to be temporary.

Fair Value

A-5. Some respondents requested guidance on the determination of fair value. AcSEC recognizes that estimating fair value requires judgment. AcSEC concluded, however, that it would be inappropriate and is unnecessary to develop a new definition of fair value in this SOP, and that the definition of fair value in FASB Statement No. 15 should be used in this SOP. Moreover, AcSEC believes that the following discussion about fair value from Statement No. 15, particularly paragraph 82, will be helpful in implementing this SOP.

Concept of Fair Value

79. Some respondents to the Exposure Draft continued to argue that all troubled debt restructurings should be accounted for as modifications of the terms of debt and that none should be accounted for as transfers of assets (paragraphs 66 and 67). Others accepted the need to account for some troubled debt restructurings as asset transfers but held that obtaining assets through foreclosure or repossession under terms included in lending agreements should be distinguished from obtaining assets in exchange for cash or in other "asset swaps." They contended that *(a)* only the form of the asset is changed by foreclosure or repossession, *(b)* the substance of a secured loan is that the lender may choose either to postpone receipt of cash or take the asset to optimize cash receipts and recovery of its investment, and *(c)* foreclosure or repossession is not the completion of a lending transaction but merely a step in the transaction that begins with lending cash and ends with collecting cash.

80. The Board rejected those arguments for the reasons given in paragraphs 71-77, emphasizing that an event in which *(a)* an asset is transferred between debtor and creditor, *(b)* the creditor relinquishes all or part of its claim against the debtor, and *(c)* the debtor is absolved of all or part of its obligation to the creditor is the kind of event that is the basis of accounting under the existing transaction-based accounting framework. To fail to recognize an event that fits the usual description of a transaction and to recognize only the lending and collection of cash as transactions would significantly change the existing accounting framework.

81. Use of the fair value of an asset transferred to measure the debtor's gain on restructuring and gain or loss on the asset's disposal or the creditor's cost of acquisition is not adopting some kind of "current value accounting." On the contrary, that use of fair value is common practice within the existing accounting framework. Paragraph 13 of this Statement explains briefly the meaning of *fair value* and refers to *APB Opinions No. 16, No. 21,* and *No. 29,* which use *fair value* in the same way and provide guidance about determining fair values within the existing accounting framework. The term *fair value* is used in essentially the same way as *market value* was used in the Discussion Memorandum to denote a possible attribute to be measured at the time a debt is restructured. *Fair value* is defined in paragraph 181 of *APB Statement No. 4* as "the approximation of exchange price in transfers in which money or money claims are not involved." Although a "money claim" is necessarily involved in transferring assets to settle a payable in a troubled debt restructuring, the troubled circumstances in which the transfer occurs make it obvious that the amount of the "money claim" does not establish an exchange price. Determining fair value of the assets transferred in a troubled debt restructuring is usually necessary to approximate an exchange price for the same reasons that determining fair value is necessary to account for transfers of assets in nonmonetary transactions (*APB Opinion No. 29*).

82. That point is emphasized in this Appendix because some respondents to the Exposure Draft apparently misunderstood the concept of fair value (paragraph 11 of the Exposure Draft and paragraph 13 of this Statement) and the discounting of expected cash flows specified in those paragraphs. *Paragraph 13 permits discounting of expected cash flows from an asset transferred or received in a troubled debt restructuring to be used to estimate fair value only if no market prices are available either for the asset or for similar assets. The sole purpose of discounting cash flows in that paragraph is to estimate a current market price as if the asset were being sold by the debtor to the creditor for cash. That estimated market price provides the equivalent of a sale price on which the debtor can base measurement of a gain on restructuring and a gain or loss on disposal of the asset and the equivalent of a purchase price on which the creditor can measure the acquisition cost of the asset. To approximate a market price, the estimate of fair value should use cash flows and discounting in the same way the marketplace does to set prices—in essence, the marketplace discounts expected future cash flows*

from a particular asset "at a rate commensurate with the risk involved" in holding the asset. An individual assessment of expected cash flows and risk may differ from what the marketplace's assessment would be, but the procedure is the same. [Emphasis added by AcSEC.]

83. In contrast to the purpose of paragraph 13, *AICPA Statement of Position No. 75-2*[31] is concerned with different measures—net realizable value to a creditor of a receivable secured by real property and net realizable value of repossessed or foreclosed property. Its method of accounting for assets obtained by foreclosure or repossession thus differs from the method specified in this Statement. It proposes discounting expected cash flows at a rate based on the creditor's "cost of money" to measure the "holding cost" of the asset until its realizable value is collected in cash. The concept of fair value in paragraph 13 does not involve questions of whether interest is a "holding cost" or "period cost" because it is concerned with estimating market price, not net realizable value, however defined. Accounting for transfers of assets in troubled debt restructurings and for the assets after transfer is, of course, governed by this Statement.

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[31] See paragraphs 59 and 60 of this Statement.

Results of Operations Related to Foreclosed Assets Held for Sale

A-6. In the exposure draft, AcSEC proposed that there should be no results of operations—revenues and expenses—from foreclosed assets while they are held for sale; net cash receipts related to forelosed assets during the holding period would have been credited to the carrying amount of the asset, and net cash payments, except for capital additions and improvements, would have been charged to income as a loss on holding the foreclosed assets. Further, in the exposure draft, AcSEC concluded that no depreciation, depletion, or amortization expense should be recorded. Many respondents objected to the exclusion of the results of operating a foreclosed asset from income; many also objected to crediting net cash receipts to the carrying amount of the asset and charging net cash payments to income. They raised questions about the conservatism of such treatment, about whether the treatment was conceptually sound, and about whether it would be practical to implement. Some comment letters also raised questions about whether it is appropriate not to depreciate foreclosed assets held for sale. After considering the comments, AcSEC decided not to adopt the method proposed in the exposure draft.

A-7. AcSEC considered various other ways to account for operations during the period foreclosed assets are held for sale, such as—

- Reporting the net of revenues and expenses in income, including charges or credits related to changes in the valuation allowance and depreciation expense on depreciable assets, for each reporting period as a gain or loss on holding the asset.
- Reporting the net of revenues and expenses in income, including charges or credits related to changes in the valuation allowance and depreciation expense on depreciable assets held or expected to be held for more than a specified length of time (for example, one year).
- Reporting the net of revenues and expenses in income, including charges or credits related to changes in the valuation allowance, and recognizing no depreciation expense.
- Crediting or debiting the net of revenues and expenses to the asset, and recognizing no depreciation expense. Changes in the valuation allowance would be included in income.

AcSEC believes that it should consider those options further and that its ultimate decision on the treatment of operations during the period foreclosed assets are held for sale should be exposed for public comment; AcSEC intends to undertake such a project. However, because AcSEC believes that its conclusion that foreclosed assets held for sale should be carried at the lower of fair value minus estimated costs to sell or cost would not change regardless of its conclusions on operations of foreclosed assets, AcSEC decided that it should issue the guidance in this SOP now, rather than delay issuing the guidance until the results of operations issues are resolved.

Foreclosed Assets Held for the Production of Income

A-8. In the exposure draft, AcSEC proposed to require that foreclosed assets held for the production of income be carried at an amount not greater than the assets' net realizable value. AcSEC decided to eliminate that statement.

Change in Classification

A-9. AcSEC also decided that, on reclassification of a foreclosed asset from the held-for-sale category, the asset should be measured and recorded as if asset had been held for the production of income since foreclosure. That decision is consistent with the consensus of the Emerging Issues Task Force in Issue 2 of Issue 90-6, where the reversal of a decision to sell an asset acquired in a business combination gives rise to an accounting as if the asset had never been held for sale.

In-Substance Foreclosed Assets

A-10. Many respondents asked for specific guidance on in-substance foreclosed assets, and they asked whether the SOP would apply to such assets. AcSEC concluded that, except for paragraphs 12 and 17, the guidance in this SOP need not be applied to in-substance foreclosures for the following reasons:

a. The accounting for in-substance foreclosed assets was not explicitly addressed in the exposure draft.

b. AcSEC would have found it difficult to resolve issues concerning senior debt related to in-substance foreclosed assets.

However, AcSEC notes that paragraph 34 of FASB Statement No. 15; paragraph 6 of AICPA Practice Bulletin 7, *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed;* and SEC Financial Reporting Release 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities,* include accounting guidance related to in-substance foreclosed assets indicating that in-substance foreclosed assets should be accounted for in the same way as assets that have actually been foreclosed or repossessed. Further, AcSEC concluded that for purposes of applying this SOP, the held-for-sale presumption could not be rebutted for in-substance foreclosed assets. Accordingly, after in-substance foreclosure, an in-substance foreclosed asset, like a foreclosed asset held for sale, would be reported in the balance sheet at the lower of (*a*) fair value minus estimated costs to sell or (*b*) cost.

Carrying Amount of Assets at Foreclosure

A-11. Some respondents expressed concerns and opinions about the carrying amount of the foreclosed assets to be recognized at foreclosure. The exposure draft indicated that the attribute to be recognized at foreclosure should be the fair value of the collateral, implying that, if at the time of foreclosure the fair value of the collateral is greater than the recorded investment in the related loan, a credit to income would result. Some respondents suggested that no such credits should be permitted and that the carrying amount of the asset recognized at foreclosure should be the lower of the fair value of the collateral or the recorded investment in the loan. Notwithstanding those concerns, AcSEC notes that paragraph 28 of FASB Statement No. 15 requires that foreclosed assets be accounted for at their fair value at the time of foreclosure.

A-12. Some respondents also said that the definition of *fair value,* which is the definition in paragraph 13 of FASB Statement No. 15, implicitly contains a reduction for selling costs. For purposes of applying this SOP, AcSEC believes that the definition of fair value in paragraph 13 of FASB Statement No. 15 should be viewed as the cash sales/purchase price in a principal-to-principal transaction wherein no agents, dealers, brokers, or commission merchants are involved. If either principal decides to involve and pay outsiders to assist that principal, or to being principals together, any amount paid by that principal is independent of the fair value of the asset and does not affect that fair value. Accordingly, immediately after foreclosure, a valuation allowance related to foreclosed assets held for sale should be recognized for estimated costs to sell through a charge to income.

Offsetting of Debt

A-13. Contrary to what was proposed by AcSEC in the exposure draft, some respondents suggested that nonrecourse senior debt not assumed by the holder of the foreclosed asset be offset against the carrying amount of the asset. To protect its interest in the asset, the holder of the asset will have to settle the debt or have a subsequent transferee take the asset subject to the debt. If debt is offset, leverage is not portrayed, and the degree of possible gain is obscured. Moreover, offsetting nonrecourse senior debt against a foreclosed asset would be inconsistent with the manner in which such debt is portrayed when assets are purchased for cash and there is related nonrecourse debt. Therefore, AcSEC reaffirms that senior debt should not be offset against the asset.

Transaction

A-14. Comments were specifically requested on the transition proposed in the exposure draft. Most respondents agreed that determining the cumulative effect of the change in accounting principle would either be impossible or possible only at significant cost for enterprises that do not have available the fair value of foreclosed assets at earlier balance sheet dates, and that a restatement of previously issued financial statements or a cumulative effect adjustment should not be required. Further, AcSEC concluded that, because one of the principal objectives of this SOP is to have consistent accounting of foreclosed assets, those two alternatives should not be permitted.

Appendix F

Schedule of Changes Made to Audits of Credit Unions

Reference	Change	Date
General	The term "examination" has been changed to "audit" to conform to the terminology used in SAS No. 58.	October, 1990
Preface	Conformed to the terminology used in SAS No. 55.	May, 1992
Paragraphs 1.04 and 2.03	Conformed to the terminology used in SAS No. 55.	May, 1992
Paragraph 2.05	Reference to SAS No. 45, paragraph 8 changed to SAS No. 45, paragraph 1 (correction of an error); Reference to SAS No. 1, section 320 deleted because of supersession by SAS No. 55.	October, 1990
Paragraph 2.12	Reference to SAS No. 34 changed to SAS No. 59.	October, 1990
Paragraph 2.12	Conformed to the terminology used in SAS No. 59.	May, 1992
Paragraph 2.15	Second standard of fieldwork conformed to current *Codification of Statements on Auditing Standards.*	October, 1990
Paragraph 2.15	Conformed to the terminology used in SAS No. 55.	May, 1992
Paragraphs 2.16, 2.17 and 2.18	Replaced by paragraphs 2.16 and 2.17 to conform to the terminology used in SAS No. 55; subsequent paragraphs renumbered.	May, 1992
Renumbered paragraph 2.18	Conformed to the terminology used in SAS No. 55.	May, 1992
Renumbered paragraph 2.19	Reference to SAS No. 20 changed to SAS No. 60.	October, 1990
Renumbered paragraph 2.19	Conformed to the terminology used in SAS No. 55.	May, 1992
Renumbered paragraph 2.20	Reference to SAS No. 30, deleted because of supersession by SAS No. 60.	October, 1990
Renumbered paragraphs 2.20 and 2.22	Conformed to the terminology used in SAS No. 55.	May, 1992
Paragraph 2.23	Added by the issuance of SAS No. 65.	May, 1992
Paragraph 2.24	Conformed to the terminology used in SAS No. 55.	May, 1992
Paragraph 2.28	Reference to superseded literature deleted.	October, 1990
Paragraph 2.28	Note reference to SAS No. 70 added; reference to the audit and accounting guide *Audits of Service-Center-Produced Records,* deleted	May, 1992
Paragraphs 2.31—2.38	Revised to conform to the concepts in SAS Nos. 53 and 54.	May, 1992

Reference		Change	Date
Paragraph	2.41	Conformed to the terminology used in SAS No. 55.	May, 1992
Paragraph	2.46	Reference to and quote from SAS No. 27 changed to SAS No. 52.	October, 1990
Paragraph	2.49	Reference to SAS No. 60 added.	October, 1990
Paragraph	2.51	The term "changes in financial position" has been changed to "cash flows" to conform to the terminology used in FASB Statement No. 95; Reference to SAS No. 14 changed to SAS No. 62; Reference to SAS No. 2 changed to SAS No. 58.	October, 1990
Paragraphs and 2.54	2.52, 2.53	SOP 90-5 integrated into text.	October, 1990
Paragraphs and 3.08	3.07	Conformed to the terminology used in SAS No. 55.	May, 1992
Paragraph (footnote 1)	4.13	Revised to refer to FASB Statement No. 91.	October, 1990
Paragraph	4.27	Footnote 2 deleted.	October, 1990
Paragraphs and 5.16	4.35, 4.36,	Conformed to the terminology used in SAS No. 55.	May, 1992
Paragraph	5.31	Reference to FASB Statement No. 91 added.	October, 1990
Paragraph	5.40	Reference related to status of EITF projects updated.	October, 1990
Paragraph	5.47	Conformed to the terminology used in SAS No. 67.	May, 1992
Paragraphs and 5.54	5.49	Conformed to the terminology used in SAS No. 55.	May, 1992
Paragraph	5.56	Note reference to SAS No. 70 added.	May, 1992
Paragraphs and 6.12	5.59	Conformed to the terminology used in SAS No. 55.	May, 1992
Paragraph	6.18	The term "error" has been changed to "misstatement" to conform to the terminology used in SAS No. 58.	October, 1990
Paragraph	7.01	Note reference added to reflect the issuance of SOP 92-3.	May, 1992
Paragraph	7.07	Reference to FASB Statement No. 98 added.	October, 1990
Paragraph	7.08	Reference to FASB Statement No. 94 added.	October, 1990
Paragraphs and 8.13	7.13, 7.16,	Conformed to the terminology used in SAS No. 55.	May, 1992
Paragraph	8.16	Reference to SAS No. 67 added.	May, 1992
Paragraphs and 10.05	9.13	Conformed to the terminology used in SAS No. 55.	May, 1992
Paragraph	11.12	Reference to SAS No. 34 changed to and terminology conformed to SAS No. 59.	October, 1990
Paragraph	12.06	Reference to SAS No. 23 changed to SAS No. 56.	October, 1990
Paragraph	12.10	Conformed to the terminology used in SAS No. 55.	May, 1992
Appendix A		Auditor's Reports conformed to SAS No. 58; Notation of issuance of FASB Statement No. 95 added.	October, 1990

Reference	Change	Date
Appendix A	Note 8 (pension plans) deleted; reference to FASB Statement No. 87 added.	May, 1992
Appendix B	Second standard of fieldwork conformed to current *Codification of Statements on Auditing Standards.*	October, 1990
Appendix B	Conformed to the terminology used in SAS No. 55.	May, 1992
Appendix C	SOP 90-5 added.	May, 1992
Appendix D	SOP 90-11 added.	March, 1991
Appendix D	References to Audit and Accounting Guide *Savings and Loan Associations* deleted.	August, 1991
Appendix D	Notice to Readers revised to reflect the issuance of SAS No. 69.	May, 1992
Appendix E	SOP 92-3 added.	May, 1992
Glossary	Reference to Veterans Administration changed to Department of Veterans Affairs.	November, 1991

In addition to the above, notes have been added to highlight areas that will be updated in future editions. These areas include:

The statement of changes in financial position in Appendix A will be replaced by a statement of cash flows.

Glossary

allowance for loan losses. A contra account established and maintained by periodic charges to operating expenses to provide a balance for absorbing possible future loan losses.

appraised value. A valuation made by an approved or licensed appraiser based on facts, assumptions, and techniques that the appraiser considers appropriate.

central liquidity facility (CLF). A corporation formed by an act of Congress to help credit unions cope with liquidity excesses or deficiencies. The CLF provides a facility for investing and for borrowing funds.

certificates of indebtedness. See **promissory notes.**

common trust fund. A commingling of individual trust funds into a common pool.

contingency reserve. An appropriation of retained earnings set aside for possible future contingent liabilities.

corporate central credit union. A credit union organized by credit unions to offer a central deposit and lending facility for credit unions.

correspondent credit union. A credit union that acts as an agent and processes transactions for members of another credit union pursuant to a service agreement between the two credit unions.

credit committee. A committee of credit union members that is responsible for the approval and general supervision of all loans to members, subject to federal and state laws. It may delegate its authority to loan officers.

Credit Union Executive Society (CUES). An organization designed to provide a forum for credit union executives to exchange ideas and to disseminate information.

dividends. The amount paid to a member in return for his or her savings in the credit union. In the aggregate, this is an expense for financial statement presentation.

dormant account. A savings account in which there has been no activity other than dividends credited for a specified period of time.

escrow. An account credited with periodic deposits by borrowers for credit union payment of real estate taxes and insurance premiums when they become due.

Federal Home Loan Mortgage Corporation (The Mortgage Corporation or FHLMC). A corporation that provides a secondary market in conventional residential mortgages. It sells mortgages and mortgage participation certificates (PCs) representing undivided interests in a group of mortgages. It is often referred to as *Freddie Mac.*

Federal National Mortgage Association (FNMA). A corporation that provides a secondary market for residential housing mortgages. It is often referred to as *Fannie Mae.*

Federal Reserve Board (FRB). A board of seven members appointed by the President and confirmed by the Senate and responsible for supervising, coordinating, and formulating monetary policy. The FRB has regulatory power over member banks and nonmember financial institutions.

Federal Reserve System. The central banking system of the United States, created by the Federal Reserve Act of 1913. The system includes national and state member banks and twelve Federal Reserve Banks and their branches.

field of membership. The group of people who qualify as members of a credit union. A credit union's field of membership is limited by law to those who have a common bond, such as a place of employment, community, or association.

Government National Mortgage Association (GNMA). A corporation wholly owned by the federal government that purchases, services, and sells mortgages insured or guaranteed by the Federal Housing Authority (FHA) and the Department of Veterans Affairs (DVA). It also performs other secondary market functions to support the home mortgage market. It is often referred to as *Ginnie Mae*.

level-yield method of interest computation. The recording of premium amortization and discount accretion in a manner that produces a constant rate of return on the carrying amount of an asset.

loan fees. An amount charged for a loan generally to cover the cost of origination and as a yield adjustment.

National Association of State Credit Union Supervisors (NAS-CUS). An organization of state credit union regulators formed to encourage legislative support for state credit unions.

open-end credit. An arrangement under which a lender provides a specified line of credit that may be used at a borrower's discretion. It is also called a *charge account or revolving credit account*.

pass-through certificates. A certificate guaranteed by GNMA, representing a share in pools of mortgages insured by the FHA, DVA, or Farmers Home Administration. The pools include mortgages with the same interest rate and approximately the same maturity. The payback to investors includes interest and principal, both guaranteed by GNMA. Such a certificate has a minimum trading unit amount.

payroll deductions receivable. A receivable due from a sponsor organization for amounts withheld from employees' salaries for a specific purpose.

promissory notes. A note issued in evidence of an agreement with a member. In essence, it constitutes a loan to the institution. *Interest* is paid on a promissory note, which is also referred to as a *certificate of indebtedness*.

repurchase agreements (repos). An agreement under which a credit union purchases securities and the seller agrees to repurchase them within a specified time at a specified price.

reverse repurchase agreements (reverse repos). An agreement under which a credit union sells securities and agrees to repurchase them within a specified time at a specified price.

savings certificates. A time-deposit certificate issued in evidence of an agreement between the financial institution and a member. A substantial penalty is required for early withdrawal of funds. *Dividends* are paid on a savings certificate.

secondary mortgage market. A market where transactions primarily between mortgage owners (who wish to sell mortgage loans) and investors (who are willing to buy mortgage loans to hold for income) involve the purchase and sale of existing mortgages. These mortgages may involve guarantees by government agencies, by private institutions, and by investors throughout the United States.

share drafts. A dividend-bearing, checklike account. A share draft is processed through regular check-clearing channels.

signature cards. A card bearing a member's signature. The card contains the contract between a member and the credit union. The card must be kept on file by the credit union for signature verification.

statutory reserve. An appropriation of retained earnings required by statute.

Student Loan Marketing Association. An organization created by an act of Congress to provide a secondary market for buying, selling, and servicing student loans. It is often referred to as *Sallie Mae*.

supervisory committee. A credit union committee that is responsible for an annual audit and for an annual report of the credit union's operations. A summary of the report is presented at the annual meeting of members.

treasury tax and loan note option accounts. In the aggregate, balances in a credit union representing payments for certain U.S. obligations and payments of federal taxes that the credit union elects to retain and pay interest on to the Treasury for short-term periods.

unappropriated retained earnings. Retained earnings of a credit union not restricted for specific purposes. It is commonly referred to by credit unions as *undivided earnings*.

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