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American Institute of Certified Public Accountants. Credit Unions Committee

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EXPOSURE DRAFT

PROPOSED AUDIT AND ACCOUNTING GUIDE

AUDITS OF CREDIT UNIONS

MARCH 20, 1992

Prepared by the Credit Unions Committee
Federal Government Division
American Institute of Certified Public Accountants

Comments should be received by June 18, 1992, and addressed to
Susan W. Hicks, Federal Government Division, File L-1-501
AICPA, 1455 Pennsylvania Avenue, N.W., Washington, DC 20004–1081

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AICPA

American Institute of Certified Public Accountants

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March 20, 1992

Accompanying this letter is an exposure draft of a proposed AICPA Audit and Accounting Guide, *Audits of Credit Unions*, that would supersede the audit and accounting guide of the same name issued in 1986. A summary of the proposed guide also accompanies this letter.

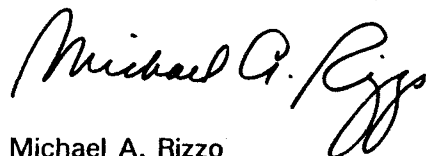
The proposed guide discusses those aspects of accounting and auditing unique to credit unions and was developed to assist accounting practitioners and auditors in preparing and auditing the financial statements of credit unions. This exposure draft incorporates new accounting and financial reporting requirements issued by the Financial Accounting Standards Board (FASB) and the AICPA Accounting Standards Executive Committee (AcSEC); no other accounting changes are proposed. Also incorporated in this exposure draft are new auditing standards issued by the AICPA since the publication in 1986 of the Audit and Accounting Guide *Audits of Credit Unions*.

Please note that this exposure draft refers to Statement on Auditing Standards (SAS) No. 70, *Reports on the Processing of Transactions by Service Organizations,* which was being prepared for publication at the time this exposure draft was issued. It is expected to be available in mid- to late April.

Comments or suggestions on any aspect of this exposure draft will be appreciated. The Credit Unions Committee's consideration of responses will be helped if the comments refer to specific paragraph numbers and include reasons for any suggestions or comments. Commenters are requested to give particular attention to the consideration of the cost of capital in the calculation of net realizable value of the underlying collateral of troubled real estate loans in the determination of an adequate allowance for loan losses (see paragraph 6.8).

Responses should be addressed to Susan W. Hicks, AICPA, Federal Government Division, 1455 Pennsylvania Avenue, N.W., Washington, DC 20004-1081, File L-1-501, in time to be received by June 18, 1992. Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the offices of the AICPA for one year.

Sincerely,



Michael A. Rizzo
Chairman
Credit Unions Committee

Gerard L. Yarnall
Director
Audit and Accounting Guides

SUMMARY

This proposed audit and accounting guide has been prepared to assist the independent auditor in auditing and reporting on the financial statements of credit unions. It describes relevant matters or procedures unique to these entities and focuses on specific problems of accounting, auditing, and reporting on their financial statements.

This proposed guide would supersede the AICPA Audit and Accounting Guide *Audits of Credit Unions* issued in 1986.

One objective of this proposed guide is to heighten auditors' awareness of the complex issues encountered in audits of credit unions' financial statements. Interest-rate risk, liquidity, asset quality, and internal control structure are among the most important concerns in the credit union industry. These areas should also be essential considerations in the auditor's assessment of risk at the financial statement level. A credit union's management must exercise considerable skill and judgment to manage interest-rate risk and maintain liquidity, asset quality, and an effective internal control structure. Similarly, the auditor of a credit union's financial statements should exercise considerable skill and judgment when considering these matters in planning and performing an audit.

Interest-rate risk, liquidity, asset quality, internal control structure, and their effect on the auditor's consideration of risk at the account-balance or class-of-transactions level are each discussed in this proposed guide. This proposed guide also describes relevant specific internal control structure policies and procedures and auditing procedures. Further, it stresses the need for industry knowledge and training in auditing certain areas, including the allowance for loan losses.

Significant accounting matters addressed in this proposed guide include establishing an adequate allowance for loan losses, valuing real estate acquired, accounting for mortgage-banking activities, accounting for business combinations, and accounting for investment securities held by a credit union.

This proposed guide includes illustrations of the form and content of financial statements for credit unions and the auditor's report thereon.

This exposure draft has been sent to —

- State society and chapter presidents, directors, and committee chairpersons.
- Organizations concerned with regulatory, supervisory, or other public disclosure of financial activities.
- Individuals and firms identified as having an interest in accounting and auditing issues that affect credit unions.
- Persons who have requested copies.

Credit Unions Committee
(1991 – 1992)

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The Credit Unions Committee also gratefully acknowledges the contributions of former committee members Christopher L. Britton, John J. Dorsey, Berten C. Fallon, James A. Higbee, David A. Kwant, Joseph L. Lents, James L. Pandolfi, and Alan S. Witt; Jerome W. Rather of the Credit Union National Association; Karen K. Kelbly and Douglas D. Verner of the National Credit Union Administration; and Daniel L. Kabat.

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PREFACE

This proposed audit and accounting guide will supersede the AICPA Audit and Accounting Guide *Audits of Credit Unions*, which was originally issued in 1986. The principal objective of this proposed guide is to help independent auditors audit and report on the financial statements of credit unions. This proposed guide has been written to be one of the principal reference sources that an auditor consults in auditing a credit union's financial statements. 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 auditors.

This proposed guide emphasizes those aspects of accounting and auditing unique to the credit union industry, reflecting the presumption that the auditor understands accounting and auditing aspects that are common to business enterprises in general; however, the discussions do not necessarily cover all situations that an auditor might encounter in a specific credit union.

This proposed guide's discussions of accounting and financial reporting matters are intended to describe current practices and should not take the place of a careful reading of the underlying authoritative literature. The proposed guide incorporates the following AICPA statements of position (SOPs) to the extent that they amended the previous guide:

1. SOP 90-5, *Inquiries of Representatives of Financial Institution Regulatory Agencies*

2. SOP 90-11, *Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets*

For issues and activities new to credit unions since the issuance of the 1986 guide, the proposed guide also incorporates or makes reference to applicable guidance in current authoritative literature specifically applicable to other financial institutions, including —

- SOP 90-3, *Definition of the Term* Substantially the Same *for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position.*

- SOP 86-1, *Reporting Repurchase-Reverse Repurchase Agreements and Mortgage-Backed Certificates by Savings and Loan Associations.*

The proposed guide also incorporates the provisions of Practice Bulletin No. 7, *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed.*

References to AICPA Statements on Auditing Standards (SASs) and to the authoritative accounting pronouncements of the Financial Accounting Standards Board (FASB) and its predecessor organizations, including the Accounting Principles Board (APB), are intended to include the specific pronouncements as well as all subsequent amendments and interpretations. The auditor should be familiar with any authoritative auditing and accounting pronouncements issued after the issuance of the proposed guide.

AICPA audit and accounting guides are included in category B of the hierarchy of generally accepted accounting principles (GAAP) established by SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report.* Category B includes literature auditors 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 Profes-

sional Conduct. This proposed guide cites accounting literature, such as minutes and consensuses of the FASB's Emerging Issues Task Force (EITF), Practice Bulletins issued by the AICPA's Accounting Standards Executive Committee (AcSEC), and AICPA Issues Papers, that is included in other categories of the hierarchy of GAAP. These citations are not intended to elevate this literature from the other categories to category B of the hierarchy of GAAP.

Finally, users of this proposed guide should also be aware that certain accounting and auditing issues affecting credit unions are currently under study by the AICPA Credit Unions Committee, AcSEC, and the FASB. These issues include recognition and measurement issues associated with financial instruments and accounting for foreclosed assets. This proposed guide includes a discussion of the proposed AICPA Statement of Position *Accounting for Foreclosed Assets* (refer to paragraphs 10.10 through 10.11). The final guide will be updated to incorporate the final conclusions of AcSEC on the appropriate accounting treatment for assets acquired by foreclosure.

EFFECTIVE DATE AND TRANSITION

The accounting and financial reporting provisions of this proposed guide reflect current authoritative literature for credit unions and other financial institutions. Accordingly, effective dates should be applied as provided for in the specific authoritative literature. The auditing provisions of this proposed guide shall be applied prospectively to financial statements of credit unions for fiscal years beginning on or after publication of the final audit guide (to be determined).

INDUSTRY BACKGROUND

INTRODUCTION

A credit union is a tax-exempt, member-owned, not-for-profit cooperative financial institution that allows those in its field of membership to pool their savings, borrow from the institution, and obtain other related financial services. Members are united by a common bond and democratically control the credit union under federal or state regulation.

Credit unions are unique among financial institutions in concept, structure, operating philosophy, and business practices. The financial services that credit unions offer their members, rather than profitability, are the primary reasons for their existence.

ORGANIZATION AND STRUCTURE

The first credit union in the United States was organized in 1909. While credit unions were originally organized within communities, greater success was achieved by organizing credit unions to serve employee groups -- particularly government employees, teachers, railway workers, and telephone company employees.

In 1934, Congress passed the Federal Credit Union Act, establishing a federal regulatory system. In 1970, the National Credit Union Administration (NCUA), an independent governmental agency, was created by Congress to charter, supervise, and regulate federal credit unions. Other legislative changes affecting credit unions include the creation of the National Credit Union Share Insurance Fund (NCUSIF) within the NCUA to insure savings in all federal credit unions and many state-chartered credit unions; the Depository Institution Deregulation and Monetary Control Act of 1980; and the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

Each credit union is organized around a defined *field of membership*, and each member shares a *common bond* of affiliation with other members that unites them in cooperation toward mutual goals. The field of membership is a key characteristic of a credit union, and is defined in its charter and bylaws as those who may belong to it and use its services. The common bond is a characteristic of the members themselves, such as occupation, religion, residence, or family relationship.

A credit union relies on volunteers who represent the members. By electing the credit union's board of directors to represent them, the members direct the formation of credit union policies and practices.

FINANCIAL STRUCTURE

Because it is a nonstock cooperative, a credit union's primary source of funds is members' share and savings account deposits. To be entitled to membership, each member must own at least one share in the credit union. Members' shares, or share accounts, are savings accounts that represent the members' ownership in the credit union. Credit unions pay dividends on shares.

These dividends cannot be guaranteed (as interest on deposits can), but must be declared by the board and may be paid from current or undivided earnings. A large number of credit unions include members' share accounts in equity or capital. For regulatory purposes, the NCUA requires that members' shares be classified as equity. *Generally accepted accounting principles require that member shares be classified as liabilities.*

Credit unions use the funds from these shares and other members' savings accounts to make loans to members and to make investments. Generally, loans to members make up the bulk of credit union assets. Funds not needed to meet member loan demand and operating expenses are invested.

DEREGULATION

Historically, credit unions have operated in a highly regulated environment in which regulations over interest rates on loans and share accounts significantly influenced operating activities. Legislation passed in the early 1980s removed most restrictions on deposit instruments and enabled credit unions to compete more freely for deposits. The introduction of various instruments, such as money market deposit accounts with more flexible terms, increased the cost of funds throughout the industry.

The increase in the cost of funds prompted by deregulation and accompanied by a rise in market dividend (interest) rates to unprecedented levels in the same time period was not entirely offset by additional interest income. To enhance profitability, many credit unions became much more aggressive in the areas of fees and charges, and real estate, short-term construction, and business lending. These areas had the potential for higher earnings, but were much higher risk activities than traditional consumer lending.

As a result of these developments, some credit unions have experienced significant asset growth and sometimes entered into high-risk transactions and activities, including aggressive lending, leveraged securities transactions, and acquisitions of complex financial instruments. Occasional adverse effects from these transactions and activities have surfaced in the form of asset-quality and liquidity problems.

CREDIT UNION SYSTEM

Credit unions, through their state and national trade associations, service organizations, and corporate credit unions, make up the *Credit Union System*. Most credit unions are affiliated with the system through membership in their state credit union leagues. In turn, credit union leagues belong to the Credit Union National Association, Inc. (CUNA), the principal trade association for credit unions in the United States, while CUNA belongs to the World Council of Credit Unions, an international credit union organization. On the national level, for-profit affiliates of CUNA, including the CUNA Service Group, the CUNA Mutual Insurance Group, and the CUNA Mortgage Corporation, provide a wide variety of products and services to credit unions on a fee basis.

Credit unions also have their own financial system, the Corporate Credit Union Network, consisting of the U.S. Central Credit Union and its forty-two member corporate credit unions. These state or regional corporate credit unions make available a wide range of investments and correspondent financial services for credit unions.

Other national credit union associations include the National Association of Federal Credit Unions (NAFCU), the Credit Union Executives Society (CUES), and other associations serving similar credit unions such as educational, defense-related, or aerospace credit unions. These groups may also provide such services as supplies, marketing, insurance, fund transfers, and investment instruments through their affiliates.

Chapter 1

ORGANIZATION AND SUPERVISION

ORGANIZATION AND STRUCTURE

1.1 As membership organizations, credit unions are democratically controlled. Federal and state laws require that a board of directors be elected on the basis of one member, one vote, and that a supervisory committee be elected or appointed by the membership. The supervisory committee, which is similar to an audit committee, plays a major role in monitoring a credit union's affairs. A credit committee may be appointed or elected to oversee the lending transactions. Other committees may include a budget or finance committee, a marketing or member-relations committee, an educational committee, and various ad hoc committees. Credit unions depend heavily on member volunteers to set policy, make decisions, and sometimes even to operate them. Some officials may receive compensation for such services, as allowed by law.

The Board of Directors

1.2 The board of directors establishes the general operation of a credit union and ensures that it follows applicable laws and regulations and adheres to its bylaws. In addition, the board is responsible for ensuring that a credit union maintains its financial stability, follows good business practices, and is properly insured and bonded.

The Supervisory Committee

1.3 The supervisory or audit committee is responsible for ensuring that member funds are protected, financial records and operations are in order, and elected officials carry out their duties properly. In addition, the supervisory committee has the responsibility for overseeing the financial reporting process and ensuring that management has established an effective internal control structure. 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.

1.4 The supervisory committee may engage an independent auditor to audit and report on the credit union's financial statements.

The Credit Committee

1.5 The credit committee carries out a credit union's loan policies, approves loan applications, and provides credit-counseling services to members. This committee may delegate some of its loan-granting authority to one or more loan officers employed by the credit union in accordance with the bylaws.

CHARTER, BYLAWS, AND MINUTES

1.6 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. The regulatory authorities generally require monthly meetings of the board of directors and other volunteer committees.

GOVERNMENT SUPERVISION

1.7 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 NCUA, which is also responsible for administering the 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. Each federally insured credit union is required to maintain a deposit with the NCUSIF in an amount equal to 1 percent of its total insured shares.

1.8 A state-chartered credit union is supervised by the regulatory agency of the chartering state. Some state-chartered credit unions have the option of obtaining NCUSIF share insurance coverage or securing insurance from other sources that are sponsored either by the state or a private insurer. Participation in an insurance program is mandatory for most credit unions.

1.9 Credit unions are subject to federal, state, and local laws applicable to financial institutions in general. Such laws include the Uniform Commercial Code, the Truth-in-Lending Laws, the Uniform Consumer Code, and various federal and state tax codes. As financial institutions, they are also subject to a wide variety of federal regulations issued by such agencies as the Treasury Department, the Federal Reserve Board (FRB) and the Internal Revenue Service (IRS).

NATIONAL CREDIT UNION ADMINISTRATION

1.10 Approximately 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. Federally insured, state-chartered credit unions sign an insurance agreement with the NCUA when they secure federal insurance that stipulates by which regulations they agree to be bound. NCUA publications that provide useful background information to credit union auditors include the following:

- *Accounting Manual for Federal Credit Unions*
- *Supervisory Committee Manual for Federal Credit Unions*
- *National Credit Union Administration Rules and Regulations* (and periodic updates)
- *The Federal Credit Union Act*
- *The Federal Credit Union Handbook*
- *Federal Credit Union Manual of Laws*

The *Accounting Manual for Federal Credit Unions* had the force of NCUA regulatory authority until 1981, when, except for section 2000 on basic accounting policies and procedures, it was deregulated.

1.11 Rules and regulations issued by the federal and state regulatory agencies, the Federal Reserve Board, and other governmental agencies address such issues as accounting practices, qualifications for membership, interest-rate controls, permissible investments, consumer-protection issues, liquidity reserves, and other operational aspects.

Enforcement Issues

1.12 In August 1989, FIRREA was passed by Congress. Its purpose was to restore the public's confidence in the savings and loan industry and ensure a safe and stable system of financing affordable housing through major regulatory reforms, strengthened capital standards, and safeguards for the disposal of recoverable assets. Certain provisions of FIRREA pertain specifically to credit unions. FIRREA significantly enhanced the NCUA's investigative and enforcement authority by liberalizing standards for cease-and-desist orders and removal-and-prohibition orders. FIRREA also established audit requirements for certain credit unions. Independent auditors should be aware of the FIRREA provision and NCUA regulations that define auditors as institution-affiliated parties and subject the independent auditor of a credit union to potential financial and criminal liability. The NCUA has the ability to assess penalties for violations of laws, regulations, written agreements, reporting requirements, and deficiencies in call reports. The penalties can be assessed against any insured depository institution and any institution-affiliated party.

1.13 The NCUA is required to publicly disclose formal and informal enforcement orders and any modifications to or terminations of such orders. Publication may be delayed for a reasonable time if disclosure would seriously threaten the safety or soundness of the credit union.

1.14 Currently, federal and most state regulators utilize a letter of understanding and agreement (LUA) or similar contractual arrangement when dealing with a troubled credit union. This signed document formalizes the negotiated agreement between the regulatory agency or agencies (the regional director represents the NCUA) and the credit union's board of directors concerning the problems, the actions to be taken, and the timetable to complete each action. In dealing with a state-chartered, non-NCUSIF-insured credit union, the state regulator usually will involve the appropriate state or private insurer. An LUA generally precedes a formal order by the regulatory agency to merge, close, or otherwise deal with an unsalvageable credit union.

REGULATORY ACCOUNTING PRACTICES

1.15 Regulatory accounting practices may differ from generally accepted accounting principles. The most common variances are—

- The maintenance of accounting records on a modified cash basis.
- The classification of members' shares as equity rather than liabilities, in accordance with regulatory requirements.
- The acceptability of settlement-date rather than trade-date accounting for investment securities.

1.16 If financial statements prepared under regulatory accounting practices are materially different from statements prepared in accordance with generally accepted accounting principles, the independent auditor should modify his or her report in accordance with SAS No. 62, *Special Reports*. The auditor's report should include a paragraph that (*a*) states the basis of presentation and refers to the note to the financial statements that describes the basis, and (*b*) states that the basis is a comprehensive basis of accounting other than generally accepted accounting principles.

The auditor's report should also include a paragraph that restricts the distribution of the report solely to those within the entity and for the purpose of filing with the regulatory agency.

ANNUAL AUDITS

1.17 A credit union may engage an independent auditor to perform the following services:

- An independent audit in accordance with generally accepted auditing standards (GAAS)
- A supervisory committee audit (an agreed-upon-procedures engagement)

Credit unions may also be subject to examinations by regulatory agencies.

1.18 As used in this proposed guide, the term *audit* refers to an audit performed by an independent auditor in accordance with generally accepted auditing standards for the purpose of expressing an opinion on a credit union's financial statements, unless the context in which the term is used clearly indicates that the reference is to an internal audit. The term *examination* generally refers to an examination made by a regulatory authority. The purpose of a regulatory examination is to determine the safety and soundness of the credit union. The regulatory examiner emphasizes the quality of assets, liquidity, adequacy of retained earnings, management ability, future earnings ability, and compliance with applicable laws and regulations. The resultant evaluation is expressed in terms of a CAMEL rating (the CAMEL system derives its name from the various components of the depository institutions that are rated: capital adequacy, asset quality, management, earnings, and liquidity).

1.19 The minimum requirements for a supervisory committee audit for federally chartered credit unions can be found in section 701.12 of the NCUA *Rules and Regulations*. State-chartered credit unions are subject to the regulatory audit requirements of the chartering state. To satisfy regulatory requirements for a supervisory committee audit, the supervisory committee may perform the required procedures itself, or it may engage an independent auditor to perform only those procedures necessary to fulfill the federal or state requirements (an agreed-upon-procedures engagement for an auditor). Because the types of engagement can differ so significantly, it is important for the independent auditor to establish a clear understanding of the nature of the engagement.

Chapter 2

AUDITING CONSIDERATIONS

INTRODUCTION

2.1 In planning the audit of a credit union, the auditor should be aware of the business and economic risk factors that affect the industry in addition to the normal risk factors. The sensitivity of earnings to changes in interest rates, the effect of deregulation on products and services available, the anticipated effect of potential legislation, increasing competition to attract and lend funds from nonfinancial entities, continuing changes in financial products and instruments, evolving accounting practices, and current regulatory developments are among the key factors that influence the business and economic risks inherent in the industry. Deregulation of the interest rates paid on insured deposits, innovations in the financial and capital markets, and increased competition may result in reduced earnings for credit unions. In addition, strengthened enforcement powers of federal regulators and increased civil sanctions have created a regulatory concern for independent auditors. The auditor should have an understanding of the regulatory environment, including the rules and policies of the National Credit Union Administration, or any other applicable regulatory agency, and the unique accounting and business risks of the industry.

PLANNING THE AUDIT

2.2 In planning the audit of the financial statements of a credit union, the auditor should perform a preliminary review of financial data (SAS No. 56, *Analytical Procedures*, paragraphs 6 through 8, describes the use of analytical procedures in planning an audit) and review internal audit reports, reports of examinations by regulatory agencies, and related correspondence. The auditor should consider performing procedures such as reviewing the charter and bylaws and reading the minutes of the meetings of the board of directors, the credit committee or the loan officers or both, the supervisory committee, and other committees, noting items that have an effect on the internal control structure and the financial affairs of the credit union.

2.3 As a part of the planning process, the auditor should assess the risks discussed in SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (see paragraphs 2.18 through 2.20), and related SAS No. 54, *Illegal Acts By Clients* (see paragraphs 2.32 through 2.36).

2.4 In addition, the auditor should consider SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (see paragraphs 2.21 and 2.22).

2.5 The auditor should consider the nature and extent of any complex and higher risk transactions in which a credit union, including any subsidiaries, has engaged, as well as management's experience in dealing with them. Auditing considerations for these transactions are addressed in subsequent chapters of this proposed guide. Due to the nature and complexity of the unique risks in the credit union industry, audit personnel experienced in the industry should take an active role in planning and supervising the audit.

TIMING OF THE AUDIT

2.6 All federally chartered and most state-chartered credit unions have a December 31 year end. The nature, timing, and extent of the audit procedures to be performed and the resulting reports to be issued are determined by the independent auditor and are based on the type of engagement.

2.7 SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AICPA, *Professional Standards*, vol. 1, AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"), identifies factors to be considered in the timing of audit procedures. The auditor may determine that a significant amount of the audit can be performed at an interim date. In such cases, SAS No. 45, paragraph 8, provides guidance on extending audit conclusions to the balance-sheet date and states that "substantive tests should be designed to cover the remaining period in such a way that the assurance from those tests and the substantive tests applied to the details provided from reliance on the internal control structure achieve the audit objectives at the balance-sheet date." Also, SAS No. 55, paragraphs 37, 38, and 53, provides guidance about the timing of tests to assess the level of control risk.

RISKS IN THE CREDIT UNION INDUSTRY

2.8 To determine the scope of audit procedures to be performed, the auditor should be aware of the economic and other factors that affect financial institutions in general and the credit union industry in particular. As supply and demand for credit fluctuates, the effect on interest rates creates risks for credit unions. As money becomes tighter and interest rates rise, various risks become more pronounced.

Economic Risks

2.9 Credit Risk. Credit risk is significant in credit unions. Several factors may cause credit risk to increase, including improper credit-extension procedures, economic conditions, and significant loan concentrations.

2.10 Interest-Rate Risk. Credit unions also face exposure to interest-rate risk. Assets of credit unions are subject to legal interest-rate ceilings and may be invested in intermediate or long-term, fixed-rate loans or securities. Such assets are often funded through interest-sensitive, short-term liabilities. If a credit union is unable to adapt to the movement of interest rates and the rates rise substantially, it must refinance short-term borrowing at higher rates, which may result in lower profit margins and, possibly, operating losses. Conversely, rate-sensitive assets funded by longer term, fixed-rate liabilities create interest-rate risk in a falling-rate environment.

2.11 Liquidity Risk. 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 or borrow to generate cash, losses or interest expense may be incurred on the transactions. The auditor should evaluate the composition of members' deposits to consider liquidity risk. Jumbo deposits may increase overall liquidity risk because large amounts of money can be withdrawn in a short period of time. If a credit union experiences financial difficulties and adverse publicity, its ability to retain members' deposits may be reduced or its cost of funds significantly increased. In that case, credit unions may be highly dependent on other forms of borrowing.

2.12 In recent years, additional sources of funds have become available through the development and enhancement of new investment vehicles, such as repurchase agreements. The secondary mortgage market has also become more established in the last several years.

Accounting and auditing considerations arising from these transactions are addressed in subsequent chapters.

2.13 If a credit union's liquidity is not sufficient to meet prospective needs and there is evidence that it may have to dispose of certain assets to increase liquidity, the auditor should consider the propriety of the classification and carrying values of assets that the credit union may sell. The auditor should also consider whether there is substantial doubt about the entity's ability to continue as a going concern, as discussed in SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern.*

Risk Management

2.14 Sound business policies suggest that the board of directors and management of a credit union should review risk exposure and devise a policy for the management of those risks. Periodic gap-analysis reports provide important information to assist in these reviews. Such reports typically specify underlying maturity and rate assumptions and the effect of different market interest-rate scenarios on earnings, net asset values, and regulatory capital. The continual comparison and evaluation by management of underlying payment streams, maturities, rates, and risks inherent in a credit union's assets and liabilities, given current and anticipated changes in market interest rates, are essential parts of the asset/liability management process. The asset/liability gap for any period of time is the difference between the amounts of assets and liabilities that will be repriced during a given period (that is, assets or liabilities the value of which changes in response to interest-rate changes). A negative gap position exists if a credit union has more liabilities than assets repricing during a given period. A positive gap exists when interest-sensitive assets exceed interest-sensitive liabilities. Historically, a negative gap position has been predominant in the credit union industry. In a rising-rate environment, a credit union with a positive gap will experience increased earnings.

2.15 Accounting and regulatory guidance in risk areas is evolving. The FASB's EITF currently spends a substantial portion of its time addressing financial institutions and instruments with off-balance-sheet arrangements. FASB Statement of Financial Accounting Standards (FASB Statement) No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, establishes requirements for disclosure of information about financial instruments with off-balance-sheet risk and concentrations of credit risk. From an auditing perspective, these off-balance-sheet arrangements are difficult to detect by analysis of the traditional financial records. Because of the complex and evolutionary nature of this area, the auditor should concentrate on obtaining an understanding of each type of transaction and the internal control structure that management has put in place to monitor these arrangements, being mindful of exposures such as inadequate collateral and poor documentation.

Audit Risks

2.16 The auditor should assess the risk of material misstatement of a credit union's financial statements in planning the audit. The matters considered in this assessment should be combined in an overall judgment by the auditor. SAS No. 53 lists management characteristics, operating and industry characteristics, and engagement characteristics that the auditor should consider in assessing this risk. Red flags that may be present in the audit of a credit union include the following conditions, many of which are discussed in detail in subsequent chapters:

- Noncompliance with regulatory-capital and other regulatory requirements
- Speculative or unusual off-balance-sheet transactions

- High rates of growth
- Poor loan documentation
- Significant nontraditional lending or investing activities that involve a high degree of risk
- Adverse regulatory reports or required regulatory actions
- Significant lending or investment activity inconsistent with management's stated strategy
- Significant purchases of loans from regions outside the credit union's market area
- Highly leveraged securities transactions
- Significant concentrations of loans
- The presence of material transactions that occur at or near the end of a reporting period
- The presence of individual transactions, such as sales of assets, that account for a material portion of reported income
- Illegal acts

2.17 An important factor to consider in assessing the risk of material misstatement in a credit union's financial statements is the potential for insider abuse. In general, *insider abuse* refers to actions by a credit union's officers or directors that are intended to benefit themselves or related parties without regard to the effect of these actions on the soundness of the credit union.

2.18 Insider abuse may involve unsound loans to insiders or related parties or even embezzlement of a credit union's funds. Indications of insider abuse include unsound lending practices, such as inadequate collateral and poor documentation, and violations of legal limits on loans to one borrower. Other red flags that may indicate possible insider abuse include—

- Loans secured by collateral that has had recent, dramatic increases in value.
- Loans of unusual size or with unusual interest rates or terms.
- Loans with unusual or questionable collateral or collateral that is inconsistent with the credit union's normal underwriting practices.
- Out-of-territory loans.
- Loans that are continuously extended or modified.
- Multiple transactions with a single party or a group of affiliated parties.

INTERNAL CONTROL STRUCTURE

2.19 SAS No. 55 requires that the independent auditor obtain an understanding of the internal control structure. The presence of an active supervisory committee or an effective internal audit department would contribute to a good control environment.

2.20 Appendix A of SAS No. 55 discusses the control environment factors that the independent auditor should consider. Among these factors are "external influences," including examinations by regulatory agencies. SAS No. 55 notes that external influences may heighten management's consciousness of, and attitude toward, the conduct and reporting of a credit union's operations, and may also prompt management to establish specific policies or procedures. Regulatory examiners' reports are relevant to an auditor's assessment of control risk and other aspects of audit planning.

In addition, there are several control procedures peculiar to the credit union industry that, if in place and functioning properly, strengthen the internal control structure, including—

- The daily reconciliations of all loan, deposit, and related interest trial balances with the general ledger.
- The daily balancing of tellers' and vault cash.
- The tellers' proof function.
- The establishment of dual controls over certain assets and records, such as vault cash, consigned items, dormant account information, and investment records.

Communication of Internal Control Structure Related Matters

2.21 The independent auditor may become aware of reportable conditions 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*, requires that such reportable conditions be reported to the audit committee or its equivalent. In a credit union, these matters are normally communicated to the supervisory committee.

2.22 SAS No. 60, paragraphs 9 through 19, describes the auditor's report on the internal control structure based solely on a study and evaluation made as part of an audit. Paragraphs 7 and 8 of SAS No. 60 address reporting on matters noted in performing agreed-upon procedures.

2.23 The auditor should be familiar with section 5140, "Internal Controls," of the NCUA's *Accounting Manual for Federal Credit Unions*, which discusses administrative and accounting controls. Subsequent chapters of this proposed guide summarize control procedures and conditions that the auditor may wish to consider when assessing control risk in connection with an audit.

COMMUNICATIONS BETWEEN INDEPENDENT AUDITORS AND EXAMINERS

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

- Request that management provide access to all reports of examination and related correspondence.[1]
- Review reports of significant examinations and related correspondence between examiners and the credit union during the period under audit through the date of the independent auditor's report.
- Communicate with the examiners, with the prior approval of the credit union, when their examination of the credit union is in process or a report on a recent examination has not been received by the credit union.

[1] Under section 931 of FIRREA, credit unions are required to furnish to the independent auditor a copy of the most recent examination report, any supervisory memorandum of understanding with the credit union, and any report of any action initiated or taken by federal or state credit union regulatory agencies.

2.25 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 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.

2.26 In addition, the independent auditor should consider attending, as an observer, with the prior approval of the credit union, the exit conference between the examiner and the credit union's board of directors (or its supervisory 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 credit union'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.

CLIENT REPRESENTATIONS

2.27 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 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, unfunded loans, and outstanding letters of credit have been adequately disclosed in the financial statements, where appropriate.
- Adequate provision has been made for any losses on, costs of, or expenses that may be incurred on securities, loans (including repossessions), or leases and real estate as of the statement-of-financial-condition date.
- Other-than-temporary declines in the values 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 credit union has made available all regulatory or examination reports, supervisory correspondence, and similar correspondence from applicable regulatory agencies.
- The credit union has complied with appropriate laws and regulations.
- The classification of securities and other investment assets—as held to maturity, held for sale, or trading—accurately reflects management's investment intentions.
- Sales with recourse have been adequately disclosed in the financial statements.
- Proper disclosure has been made regarding the nature, terms, and credit risk of financial instruments with off-balance-sheet risk.
- Proper disclosure has been made about financial instruments with significant individual or group concentrations of credit risk.

COMPLIANCE WITH REGULATIONS

2.28 In planning the audit, SAS No. 22, *Planning and Supervision*, paragraph 7, states that the auditor should consider "matters affecting the industry in which the entity operates, such as economic conditions, government regulations, and changes in technology as they relate to the audit." The auditor considers government regulations in light of how they might affect the financial statement assertions.

2.29 The auditor should recognize that certain laws and regulations have a known relationship to the audit objectives derived from financial statement assertions, and that a credit union's compliance with such laws and regulations is ordinarily tested as an integral part of applying normal audit procedures.

2.30 The auditor's responsibility for consideration of laws and regulations and how they affect the audit is described in SAS No. 54. SAS No. 54 provides guidance in dealing with an act that appears to be illegal, discusses the amount of attention the auditor should give when performing an audit, and sets forth conditions applicable to notification of other parties. The auditor should be aware of the possibility that illegal acts may have occurred that could have a material effect on the credit union's financial statements. Although the ultimate responsibility for compliance with applicable laws and regulations rests with management, auditors should consider laws and regulations that have a direct and material effect on the amounts presented in the financial statements. Thus, the auditor should design the audit to provide reasonable assurance that a credit union's financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts.

2.31 These laws and regulations include, for example, limitations on investment options and amounts. Because such requirements can affect the classification and valuation of assets, the auditor should plan the audit to obtain reasonable assurance that any violation of these laws and regulations has not caused a material misstatement of a credit union's financial statements.

2.32 As described in SAS No. 54, paragraph 6, entities may be affected by many other laws or regulations, such as those related to securities trading and occupational safety. Generally, these laws and regulations relate more to an entity's operating aspects than to its financial and accounting aspects. In this regard, their financial statement effect is indirect since the effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality.

2.33 Examples of such other laws and regulations are those that require a credit union to report certain financial transactions to governmental agencies. The failure to comply could subject a credit union to severe penalties. The auditor should recognize these possibilities and their potential adverse effect on the financial statements. If information comes to the auditor's attention that provides evidence of noncompliance with these regulations, the auditor should follow the guidance in SAS No. 54. Examples of areas in which noncompliance penalties may be imposed on a credit union include—

- The backup withholding of income taxes on interest paid on deposit accounts.
- The reporting of mortgage interest.
- The reporting of currency transactions to the Department of the Treasury.
- Limitations on loans to one borrower.

2.34 The independent auditor should consider what impact noncompliance with various regulations may have on a credit union when planning and conducting the audit. The independent auditor should review reports of significant examinations and related communications between examiners and the credit union and, when appropriate, make inquiries of the examiners regarding the credit union's compliance with applicable laws and regulations.

AUDITOR'S REPORTS

2.35 As previously discussed, the types of reports to be issued are based on the scope of services required. Early in the audit, the auditor should establish an understanding with the credit union regarding the services to be performed and the reports to be issued. Following are some typical services the auditor may be engaged to perform:

- Reporting on the financial statements of the credit union
- Reporting on agreed-upon procedures performed to assist the supervisory committee in fulfilling its responsibilities
- Reporting on the internal control structure
- Reporting on supplemental financial and other information
- Reporting on mortgage-banking activities (see further discussion in chapter 7)

2.36 The auditor's standard report on the financial statements of a credit union prepared in accordance with GAAP should be prepared in accordance with SAS No. 58, *Reports on Audited Financial Statements*.

Chapter 3

CASH

INTRODUCTION

3.1 Cash includes cash on deposit in other depository institutions, cash on hand, and cash equivalents.

3.2 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 bear interest.

3.3 Cash on hand consists primarily of a change fund and petty-cash funds. A credit union's change fund is a supply of currency, coins, and cash items (for example, stamps). The fund often consists of the tellers' working funds, a reserve fund kept in the vault, or vault funds in transit. It may also include a currency supply for and in automated teller machines (ATMs). Each teller should be individually responsible for the funds in his or her possession, but supervisory personnel should control the vault reserve fund.

3.4 Cash equivalents are short-term, highly liquid investments that are both readily convertible to known amounts of cash and so near their maturity that they present an insignificant risk of incurring changes in value because of changes in interest rates.

3.5 A credit union may also have consignment items, such as travelers checks, money orders, and U.S. savings bonds, that could easily be converted into cash and therefore should be controlled.

FINANCIAL STATEMENT PRESENTATION

3.6 The financial statement caption normally should read "Cash and Cash Equivalents," unless the credit union has no cash equivalents. However, cash not subject to immediate withdrawal or restricted in some other manner should be properly disclosed and may require separate reporting in the statement of financial condition. See chapter 14 for a discussion of the statement of cash flows.

AUDIT OBJECTIVES AND PROCEDURES

Audit Objectives

3.7 The primary audit objectives for cash are to determine that—

- Cash exists and is owned by the entity.
- Cash balances reflect a proper cutoff of cash receipts and disbursements, and reconciling items will clear in the normal course of business.
- Cash balances are properly classified in the financial statements in accordance with generally accepted accounting principles, and any restrictions on the availability of funds are disclosed.

Planning Considerations

3.8 Cash may be 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.

Internal Control Structure

3.9 Because of the negotiability of the items included in cash, having an effective internal control structure in this area is important. The auditor should obtain an understanding of the internal control structure related to cash and assess the level of control risk associated with this highly liquid asset.

3.10 Examples of typical internal control structure policies and procedures relating to cash include the following:

- Cash is counted and reconciled on a timely basis.
- Tellers have exclusive access to and custody of their respective funds, cash items, and consignment items.
- Access to the night depository is under the control of two employees, both of whom must be present when the safe contents are removed, listed, and processed.
- Cash items are reviewed daily for propriety by an officer or a supervisory employee other than the custodian of the items.
- Each of the functions of cash disbursement, posting to subsidiary and general ledgers, and reconciliation is performed by a different employee.
- Confirmation requests received from depository banks, supervisory examiners, and other parties are processed by an employee other than the one reconciling the account.
- Surprise counts of all cash and cash items are performed.
- Teller fund amounts are limited.
- Physical storage facilities are adequate to safeguard currency and coins against theft or other misappropriation.
- Management evaluates the financial strength of institutions in which the credit union has deposits in excess of insured limits.
- Management reviews the reporting of currency transactions to the Department of the Treasury.
- Vault cash (reserve fund) is under dual control.
- Reports to regulators are reviewed for compliance with reserve requirements.
- Bank accounts used for ATM transactions are reconciled on a daily basis.

3.11 Increasingly, many credit unions are using wire transfers, particularly for large sums of cash. Having an internal control structure over these transfers is particularly important because of the risk of fraudulent wire-transfer activity. If there is an increase in wire-transfer activities, the

testing of the internal control structure should be expanded in accordance with the auditor's assessment of control risk in the area.

3.12 Examples of typical internal control structure policies and procedures relating to wire transfers include the following:

- The duties of origination, testing, processing, and balancing of wire-transfer requests are segregated.
- Proper authorization is given for wire disbursements exceeding the available balances in share accounts or other deposits.
- Written agreements are established and maintained for all members making funds or securities-transfer requests, particularly for those members who initiate transfer requests by telephone or other means that do not provide for signed authorization. These agreements should clearly set forth the scope of the credit union's liability.
- Rejected transactions and correcting and reversing entries are reviewed by the supervisor.
- Copies of funds transfers are provided to members on a timely basis.
- Written instructions concerning the wire-transfer function are complete and current.
- Authorized caller codes are used and are changed periodically as well as each time there is a change in the employee assigned to that task.
- A current list of personnel authorized to initiate wire transfers is maintained.
- Access to the wire equipment area is physically restricted.
- Holds are placed on member accounts by wire operations personnel when instructions are received directly from the authorized member to confirm that available funds are in the member's account or that the transfer funds are within authorized limits before the transfer is made.
- Card files or authorization letters are on file for members who request telephone transfers directly from the wire function.
- Periodic follow-up audits of third-party wire transfers are performed.

Tests of Controls

3.13 Tests of controls for cash are often performed concurrently with substantive tests.

3.14 Examples of specific procedures that the auditor should consider performing to test the operating effectiveness of internal control structure policies and procedures relating to cash include determining that—

- Adequate segregation of duties exists with respect to the handling and reconciliation of cash.
- Surprise cash counts of teller and vault funds are performed periodically.
- Proper control of mail receipts and supplies of consigned items is maintained.
- Reconciliations are performed and reviewed in a timely manner.

3.15 Examples of specific procedures that the auditor should consider performing to test the operating effectiveness of internal control structure policies and procedures relating to wire transfers include determining that—

- Sequence numbers on transfers sent and received are unique and consecutive.
- Acknowledgments are returned for all outgoing messages.
- The total number and dollar amount of funds- and securities-transfer messages sent and received are compared, at least on an end-of-day basis, with summaries received from the Federal Reserve.
- Differences on daily-reserve or clearing-account statements are reconciled and any discrepancies are investigated.

Substantive Tests

3.16 The auditor should determine the nature, timing, and extent of substantive tests based on his or her understanding of the internal control structure for cash and on his or her assessment of control risk in this area. Typical substantive audit tests that the auditor should consider include—

- Counting cash and controlling undeposited receipts.
- Testing tellers' proof sheets.
- Testing bank reconciliations.
- Reviewing cash-over and -short summaries.
- Testing interbank transfers.
- Reconciling subsidiary ledgers to the general ledger.
- Testing the propriety of authorized accounts and signatures.
- Reviewing the composition of suspense accounts, especially noting the recurring use of such accounts and the failure or inability to reconcile the cash account.
- Confirming account balances.
- Testing currency-transaction reports filed with the Department of the Treasury.
- Considering positive confirmation of consigned items from consignors.

These tests may concurrently provide evidence related to the objectives of tests of controls and substantive tests.

Chapter 4

INVESTMENT SECURITIES

INTRODUCTION

4.1 Credit union funds are managed in such a way as to allow alternatives in the choice of assets, with the investment objective being an optimum balance of safety, liquidity, and yield. Safety and yield generally exhibit an inverse relationship: the lower the quality of an asset, the higher the return expected by the investor. Liquidity and yield also generally exhibit an inverse relationship: the longer the maturity of an asset, the higher the return expected by the investor. Achieving the proper mix of safety, liquidity, and yield in a credit union's investment portfolio is the primary task of management.

4.2 A credit union's income objectives are normally attained through lending operations; the higher risk and reduced liquidity of a loan portfolio allow a credit union to earn higher yields, and thus to maximize the spread between the yield it earns and its cost of funds. A credit union's liquidity objectives are normally attained through its investment securities portfolio. 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. Further, securities may be required to be pledged as a guarantee of the collectibility of certain government deposits or as collateral for borrowings. At the same time, a credit union's management seeks to maximize the return on its investment portfolio without jeopardizing the liquidity the portfolio provides.

INVESTMENT ACTIVITIES

4.3 Federal and state regulations, particularly those restricting the types of investments available to credit unions, affect credit union investment decisions. Credit union investments are generally limited to—

- Investments in corporate 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.
- Privately issued mortgage-backed securities.
- Common trust or mutual investment funds.
- Investments in the Central Liquidity Facility.
- Investment deposits in any federally insured financial institution.
- Repurchase agreements.
- Mortgage-related derivatives, such as stripped mortgage-backed securities, collateralized mortgage obligations, and asset-backed security residuals.
- Investments in other credit unions.
- Purchased put options related to loans held for sale.

- Other investments, as outlined in *The Federal Credit Union Act*, section 107; the NCUA *Rules and Regulations*, part 703, "Investment and Deposit Activities"; NCUA Interpretive Ruling and Policy Statement No. 88-1, *Policy on Selection of Securities Dealers and Unsuitable Investment Practices* (an interpretation of the FFIEC Policy Statement *Selection of Securities Dealers and Unsuitable Investment Practices*, April 1988[2]); or similar state statutes.

4.4 As a result of the failure or the weakening of credit unions that have engaged in speculative investment practices, certain investment vehicles have been determined by regulators to be impermissible. The NCUA generally requires immediate disposal of unauthorized investments, which may result in substantial losses to the credit union upon disposition. The following are currently *unauthorized* (prohibited) investments for a federal credit union:

- Wash sales (sales of securities with the intent to re-acquire the same or "substantially the same" securities, most often to obtain a lower cost of funding or other benefits). In such transactions the period of time between sale and reacquisition varies. It is often very short, especially when securities with a ready market are involved. SOP 90-3 establishes criteria to determine if debt instruments, including mortgage-backed securities, are "substantially the same."
- Standby commitments to purchase or sell a security.
- Adjusted trading or short sales (sales of securities not owned at the time of sale, with the intention that substantially the same securities will be acquired at a future date to cover the sale). In the interim, an institution is generally able to deliver securities sold short to the buyer by borrowing the securities from a third party, by obtaining the buyer's acceptance of its secured promise to deliver securities purchased at a future date, or by delivering a due bill.
- Futures and other options contracts, except purchased put options related to loans held for sale.
- Pair-off transactions (matching or netting of commitments to purchase and sell securities via cash-forward agreements).
- Common stocks, except for credit union service organizations (CUSOs).
- Corporate debt obligations.
- Equity participations in commercial real estate projects.

The auditor should be aware that the investment environment is constantly changing; new products become available, and changes frequently occur in existing investment vehicles. The preceding lists are not intended to be all-inclusive. The auditor should also be aware of any limitations imposed on state-regulated credit unions.

4.5 A brief discussion of several of the most common investment vehicles follows.

[2] The Federal Financial Institutions Examination Council (FFIEC) has exposed for comment a revision of the 1988 *Supervisory Policy* that proposes new regulatory guidance. The auditor should be alert for the issuance of any final regulatory guidance.

Corporate Credit Union Network

4.6 The Corporate Credit Union Network (the Network) serves as a primary investment alternative for many credit unions. The Network consists of the U.S. Central Credit Union and the various corporate credit unions. U.S. Central "wholesales" financial and payment services to the corporate credit unions, which in turn act as financial intermediaries on behalf of the individual credit unions. Surplus funds of the individual credit unions are aggregated in the corporate credit unions for investment through U.S. Central. U.S. Central's investment objectives are to offer competitive yields on investments while maintaining safety and liquidity. Overnight investment alternatives include regular daily shares and overnight certificates. Term investment alternatives, with maturities of two days to five years and longer, include liquidity, high-yield and redeemable shares, and variable-rate shares and certificates.

Debt Securities

4.7 The most common forms of investment securities held by credit unions are debt securities, issued by the U.S. government or a government-sponsored enterprise, for which issuers promise to pay a set principal amount at a given maturity date, as well as additional payments of interest, at either a fixed rate or a variable rate tied to an independent benchmark, during the term of the security.

Mortgage-Backed Securities

4.8 Mortgage-backed securities (MBSs) represent a participation in an organized pool of mortgages (single-family, multifamily, and in some cases commercial real estate properties), the principal and interest payments on which are passed from the mortgage originators, through intermediaries (generally quasi-governmental agencies) that pool and repackage them in the form of securities, to investors. The quasi-governmental agencies that guarantee the payment of principal and interest to investors include the Government National Mortgage Association (GNMA), or Ginnie Mae; the Federal National Mortgage Association (FNMA), or Fannie Mae; and the Federal Home Loan Mortgage Corporation (FHLMC), or Freddie Mac. MBSs are generally referred to as *mortgage-participation certificates* or *pass-through certificates*. MBSs issued by the FHLMC, the FNMA, or the GNMA represent the majority of the pass-through market. Common characteristics of MBSs include the following:

- Certificates are issued with stated minimum principal amounts.
- Pools of mortgages typically have loans with interest rates within a range.
- Maturities of the underlying mortgages generally vary.
- A pool generally comprises one of the following types of mortgage products: fixed rate, adjustable rate, or single or multifamily.

Mortgage-Related Derivatives

4.9 The secondary mortgage market has introduced new instruments, collectively referred to herein as *mortgage-related derivative products* (mortgage derivatives). Mortgage derivatives include stripped mortgage-backed securities (that is, interest-only securities and principal-only securities), collateralized mortgage obligations (CMOs), and pass-through mortgage-backed securities with senior/subordinated structures. These securities are referred to as *derivatives* since they are derived by segregating or partitioning cash flows from mortgage pass-through securities or from pools of mortgage loans.

4.10 Mortgage derivatives provide investors with a broad range of mortgage investment vehicles by tailoring cash flows from mortgages to meet the varied risk and return preferences of investors. These securities enable the issuer to "carve up" the cash flows from the underlying securities and thereby create multiple classes of securities with different maturity and risk characteristics.

4.11 Derivative products may be useful investment vehicles or tools for managing interest-rate risk, but they may also expose a credit union to a considerable risk of loss if they are not managed in an effective manner. In part, the high-risk nature of these products stems from their price volatility. Many mortgage derivatives, standing alone, exhibit considerably more price volatility than standard mortgage pass-through securities. In addition, because these securities are complex, a high degree of technical expertise is required to understand how they behave under various interest-rate and prepayment scenarios.

Mutual Funds

4.12 Federal credit unions are allowed to invest in mutual funds that represent shares of pooled investment securities. Such investments are restricted to funds that hold otherwise allowable investment vehicles. However, in contrast to debt securities, the perpetual nature of open-ended mutual funds does not afford an investor the opportunity to hold to maturity in order to ensure recovery of the initial investment. Accordingly, investing in a mutual fund possesses a certain degree of principal risk.

Repurchase Agreements

4.13 A repurchase agreement (repo) is an agreement between a buyer and a seller, usually of U.S. government securities or mortgage-backed securities, whereby the buyer agrees to resell the securities at an agreed-upon price and at a stated time. Such a transaction is equivalent to a collateralized lending and borrowing of funds equal to the purchase price of the related collateral. The attraction of repos to credit unions that buy securities (loan funds) under repurchase agreements is the flexibility of their maturities, which makes them ideal instruments in which to invest funds on a very temporary basis.

4.14 A reverse-repurchase agreement (RRP) is an agreement to sell and repurchase identical securities within a specified time at a specified price. Most of the risks faced by seller-borrowers that enter into RRPs are also faced by buyer-lenders that enter into repos. If a buyer-lender under a repo agreement with a securities dealer does not perfect a security interest in securities purchased, for example, by having a signed agreement and by taking possession, either directly or through a custodian acting as its agent, the potential economic loss also extends to the full value of the securities and the risk assumed becomes that of an unsecured lender, namely, credit risk. Collateral risk for the buyer-lender is reduced if definitive collateral is held by the dealer's custodian as the dealer's agent with specific identification of the assignee or if book-entry collateral is transferred directly by a notation entry. When definitive collateral is locked up by the dealer in safekeeping and segregated and identified by member, collateral risk will be reduced only if the dealer's internal control structure related to securities held in safekeeping is effective. Collateral risk is reduced further if the buyer-lender or its agent, which could be the dealer's bank acting as the buyer-lender's agent, takes possession of the collateral.

Hedging Instruments

4.15 Many financial products have been developed to reduce a credit union's risk from changes in interest rates. These products, when properly used, can reduce a credit union's risk of loss from volatile movements in interest rates. This is accomplished by transferring the risk to a third party. Interest-rate futures contracts, options, and interest-rate swaps are financial products

commonly used in the marketplace to manage and minimize interest-rate risk; when used in such a manner, these products are known as *hedging instruments*. These products can also be used as highly volatile speculative investments. Because of leverage, these instruments are very sensitive to market price movement, and if used improperly can expose an institution to a high degree of risk. Currently, federal credit unions are limited to long positions on put options for GNMA, FNMA, and FHLMC securities. A long position on a put option for one of these financial instruments protects the credit union against increased interest-rate price risk (which would decrease the value of the hedged security). The option increases in value as interest rates increase. Because it is an option contract, the maximum potential cost, the up-front fee (option premium), is known at the outset.

4.16 Federal credit unions may purchase put options only to reduce the risk of loss from interest-rate increases on loans being produced for sale on the secondary market. At this time, federal credit unions are not permitted to purchase put options to limit risk on loans produced or held in their loan portfolios for investment.

ACCOUNTING PRINCIPLES: MEASUREMENT AND DISCLOSURE

Premiums and Discounts

4.17 Investment securities may be acquired at par value, at a premium (a price greater than face value), or at a discount (a price less than face value). A premium paid for an investment 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, an investment 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 investment during the holding period is systematically adjusted to the amount anticipated to be realized at the maturity date and included in interest income. Amortization of premium or accretion of discount should be recorded in a manner that produces a constant rate of return on the basis of adjusted book value (interest method) in accordance with the provisions of FASB Statement No. 91,[3] *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.

4.18 The period of amortization or accretion is from the purchase date to the maturity date. The use of maturity dates for determining the amortization period for mortgage-backed securities is not necessary when a credit union holds a large number of similar loans for which prepayments are probable and the timing and the amount of the prepayment can be reasonably estimated. In these situations, a credit union can consider estimates of future principal payments in determining the amortization period for calculation of the constant yield.

Carrying Value of Investments and Financial Statement Presentation

4.19 The accrual basis of accounting requires that purchases and sales of securities be recorded on a trade-date basis. If the settlement date is after the financial statement date, however, and (*a*) the purchases or sales do not significantly affect the composition of a credit union's assets,

[3] In September 1991 the FASB issued an exposure draft of a proposed Statement, *Accounting for Investments with Prepayment Risk*, which would amend FASB Statement No. 91 to require prepayments to be anticipated in the application of the interest method of amortization whenever prepayments are considered probable, can be reasonably estimated, and the effect on the effective yield of anticipating prepayments would be significant. Readers should be alert for the issuance of final guidance in this area.

and (*b*) the resulting gain or loss on the sales of the securities is not material, accounting on a settlement-date basis for such sales and purchases is acceptable.

4.20 Investments in debt securities and similar assets should be classified into one of three categories: (*a*) assets held for investment; (*b*) assets held for sale; and (*c*) assets held for trading purposes.[4] Each of these categories requires a different accounting treatment, as discussed in the following paragraphs.

4.21 The appropriate accounting treatment for investment securities that management has the intent and ability to hold to maturity is to carry such assets at cost, adjusted for amortization of premiums or accretion of discounts, and to recognize in income only realized gains or losses. An assessment must be made to determine whether any decline in market value is other than temporary, in which case the security would be written down to a new cost basis, and the writedown would be a realized loss, as described in FASB Statement No. 12, *Accounting for Certain Marketable Securities*, and in "Long-Term Investments: Auditing Interpretations of AU Section 332" (AICPA, *Professional Standards*, vol. 1, AU sec. 9332.09).

4.22 Assets held for sale should be valued at the lower of aggregate cost or market. Trading assets should be carried at market value. Changes in the valuation allowance related to investments held for sale and changes in the market value of trading securities should be recognized in current operations.

4.23 Market values of individual securities should be obtained from published quotations or other independent sources. Gains and losses from investment security sales should be reported as of the trade date in the statement of operations for the period in which securities are sold or otherwise disposed of.

4.24 *Transfers Among Classifications*. Securities may be transferred from the assets-held-for-investment to the assets-held-for-sale account. These securities should be transferred at amortized cost, and the lower-of-cost-or-market method should be applied immediately. If a certain dollar amount of securities needs to be transferred but specific securities cannot be designated for transfer, an appropriate portion of the amortized cost of a credit union's securities treated as held for investment should be transferred to the assets-held-for-sale account. In such cases, the market value assigned to that amortized cost should be based on the relationship of the amortized cost and the market value of total securities designated as held for investment prior to transfer. When specific securities are subsequently designated as held for sale, they should be transferred to the assets-held-for-sale account at amortized cost on the date of transfer, and a related portion of the assigned market value should be replaced by the market value of the specific securities.

4.25 Securities may be transferred from the held-for-sale account to the held-for-investment account. These assets should be transferred at the lower of amortized cost or market value at the date of transfer. If the market value is less than the amortized cost, the market value should become the new cost basis.

4.26 Securities may be transferred to or from trading accounts; however, transfers from the assets-held-for-sale to the trading account should be extremely rare. The securities should be transferred at market value at the date of transfer, and the market value should become the new

[4] In June 1991, the FASB decided to accelerate the portion of its financial instruments project on recognition and measurement issues related to accounting for debt instruments held as assets. Readers should be alert for the issuance of final accounting standards issued by the FASB in this area.

cost basis for the investments. No gain should be recognized on such transfers; the amount by which such investments are written up, if any, should be deferred until the final disposition of the investments.

4.27 Investment securities should be presented in the statement of financial condition by investment category (that is, investment assets, assets held for sale, and trading assets). For investment assets and assets held for sale recorded at cost, the notes to the financial statements should also disclose the aggregate market value by category. Further, the notes should break down investments by type, with year-end weighted average yields and maturities also disclosed.

4.28 Credit unions should also include in the notes to their financial statements an explanation of their accounting policies for debt securities held, including the basis for classification into statement-of-financial-condition captions, such as investment or trading. Securities that are pledged for borrowing or other purposes should be disclosed in the financial statements or the notes thereto. The notes to the financial statements should also disclose the following information concerning debt securities held as assets:[5]

- For each statement of financial condition presented, the amortized cost,[6] estimated market values, gross unrealized gains, and gross unrealized losses for each pertinent category. Examples of such categories are—
  - Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies.
  - Mortgage-backed securities.
  - Other debt securities.
- For the most recent statement of financial condition, the amortized cost and estimated market values of debt securities due—
  - In one year or less.
  - After one year through five years.
  - After five years through ten years.
  - After ten years.[7]

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[5] If a credit union 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.

[6] 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 writedown of the debt security. Total amortized cost presented in this disclosure should be reconciled to the amounts presented in the statement of financial condition, if different.

[7] 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.

- For each period for which results of operations are presented, the proceeds from sales[8] of such debt securities and gross realized gains and gross realized losses on such sales.

4.29 _Mortgage-Backed Securities_. The accounting treatment of MBSs parallels that of other investments. MBSs held for investment are reported at amortized cost (that is, adjusted for amortization of premium or discount and prepayments). MBSs held for sale are reported at the lower of aggregate cost or market value, determined as of the statement-of-financial-condition date. The amount by which cost exceeds market value is accounted for as a valuation allowance. Changes in the valuation allowances are included in the determination of the net income of the period in which the change occurs. MBSs held in a trading account are reported at market value. Changes in the market values are accounted for as adjustments to the recorded investment.

4.30 Investments in mortgage-backed securities usually should be reported separately in the statement of financial condition, rather than being included in mortgage loans or investments. The market value of mortgage-backed securities should be disclosed in the financial statements and the notes should disclose the method of determining the carrying value of mortgage-backed securities. In addition, the disclosure requirements described in paragraph 4.27 also apply to mortgage-backed securities.

4.31 _Mortgage-Related Derivatives_. *Interest-only certificates* (IOs) are mortgage-backed securities in which an investor has purchased a portion or all of the cash flows designated as interest. The purchase price of an IO is equal to the expected future cash flows discounted at the market's current rate for an IO investment. The FASB's EITF in its Consensus No. 89-4, *Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*, has concluded that mortgage-backed IOs should be accounted for in the same manner as high-risk non-equity CMO instruments. IOs that are not considered "high risk," such as interest-only strips of U.S. government bonds, should be accounted for in accordance with the provisions of FASB Statement No. 91.[9]

4.32 The EITF indicated that interest should be accrued by applying the interest method assuming prepayments (rather than applying the interest method allowed by FASB Statement No. 91, which does not assume prepayments).[10]

4.33 The anticipated annual effective yield, or internal rate of return, on an IO is calculated at the date of acquisition based on the purchase price and expected future cash flows that reflect assumed mortgage prepayments. In the first accounting period, interest is calculated on the investment balance using the effective yield. Cash received is applied to accrued interest; any excess cash is used to reduce the investment balance. At the end of each subsequent reporting period, the effective annual yield is recalculated based on the amortized cost of the investment and expected future cash payments that reflect revised assumptions about prepayment rates.

4.34 _Principal-Only Certificates_. *Principal-only certificates* (POs) are similar to IOs, except that an investor has purchased a portion or all of the cash flows of a mortgaged-backed security designated as principal. Although the EITF did not specifically address POs in its Consensus No.

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[8] 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 SOP 90-11, 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.

[9] See footnote 4.

[10] See footnote 4.

86-38, *Implications of Mortgage Prepayments on Amortization of Servicing Rights*, the accounting applied to IOs is also usually applied to POs. In general, purchase discounts are recognized by the interest method over the contractual life of the related instrument. Prepayments may be estimated in the application of the interest method if the criteria of paragraph 19 of FASB Statement No. 91 are met. A PO derived from an MBS would ordinarily meet these criteria.

4.35 Asset-Backed Residuals. Asset-backed residuals are the excess cash flows from an asset-backed securities transaction after the payments due to the bondholders and administrative expenses have been satisfied. They have many of the characteristics of interest-only securities. The amount and timing of excess cash flows that accrue to the residual holder depend largely on the speed at which the underlying collateral prepays and on prevailing interest rates. Since these variables can change significantly over the residual's term, yields on asset-backed residuals can fluctuate widely; in extreme cases, a credit union could fail to recover all of its original investment.

4.36 The accounting for purchased investments in CMO residuals is discussed in EITF Consensus No. 89-4, which states that the accounting should follow the investment's form. However, CMO instruments in the form of equity that meet certain specified criteria are required to be accounted for as non-equity instruments. Non-equity CMOs that have the potential for loss of a significant portion of the original investment due to changes in (*a*) interest rates, (*b*) the prepayment rate of the assets of the CMO structure, or (*c*) earnings from the temporary investment of cash collected by the CMO structure but not yet distributed to investors should be amortized using a prospective interest method. Other non-equity CMOs should be accounted for in accordance with the provisions of FASB Statement No. 91. CMO instruments issued in the form of equity that do not meet the criteria for treatment as debt instruments should be accounted for under the provisions of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, or Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, as amended by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*.[11]

4.37 Financial statement presentation of investments in mortgage derivatives varies somewhat in practice. Generally, mortgage derivatives are included in "Mortgage-Backed Securities" or "Investments" on the face of the statement of financial condition. If sufficiently material, they may be presented separately.

4.38 Note disclosures should include a classification of the carrying amount and fair value of mortgage derivatives by major category, for example, (*a*) interest-only securities, (*b*) principal-only securities, and (*c*) residuals. Other categories should be presented if they are necessary to disclose unusual risk characteristics. In addition, the disclosure requirements described in paragraph 4.27 also apply to mortgage-related derivatives.

4.39 The summary of significant accounting policies should describe the method of accounting for investments in mortgage derivatives, as well as disclose the significant factors, such as prepayments and interest rates, that may affect the yield on, or recoverability of, the carrying amount.

4.40 Mutual Funds. Open-ended mutual funds are considered marketable equity securities. Marketable equity securities should be accounted for in accordance with FASB Statement No. 12. Marketable equity securities held for investment or for sale should be accounted for at the lower of aggregate cost or market value. Marketable equity securities held for trading purposes should

[11] See footnote 4.

be accounted for at market value.[12] The amount by which the aggregate cost of the marketable equity securities in an investment portfolio exceeds the estimated market value should be accounted for as a valuation allowance component of equity. Changes in the valuation allowance related to securities held for sale and changes in the market value of trading securities should be reported in the statement of operations.

4.41 _Repurchase Agreements_. Repurchase agreements (repos) are accounted for in the same way that reverse repos are, as discussed in chapter 9. Repurchase agreements should be presented gross and not netted against reverse-repurchase agreements (liabilities) on the statement of financial condition. The following should be disclosed in the financial statements or in the notes to the financial statements with respect to repos:

a. Disclosures for the end of the period should include the following:

   — A description of the securities underlying the agreements.

   — The cost of the agreements, including accrued interest.

   — The market value of the securities underlying any agreement if it is less than the cost of that agreement.

   — The maturity of the agreements.

   — The dollar amount of agreements to resell the same securities.

   — The dollar amount of agreements to resell substantially identical securities.

   — Any material concentrations at the end of the period.[13] If any material concentrations exist at the end of the period, disclosure should be made of the credit union's control of the securities underlying the agreements.[14] If concentrations at the end of the period vary from those during the period, consideration should be given to disclosing this information.

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[12] See footnote 4.

[13] *Material concentration* refers to the dollar amount of assets at risk under agreements outstanding at the report date with any one dealer. *Assets at risk* is defined as the amount of funds advanced plus accrued interest if the securities underlying the agreements are not in the possession of the credit union or its agent. If the securities underlying the agreements are in the possession of the credit union or its agent, *assets at risk* is defined as the amount of funds advanced plus accrued interest less the market value of the securities underlying the agreements if less than cost. Materiality should be considered in relation to the credit union's net worth as well as to its operations.

[14] *Control* refers to the ability of the credit union to exercise legal authority over the securities that serve as the collateral for the agreement in the event of default by the counterparty. The credit union has a different loss exposure if it lacks control over the collateral in a repurchase transaction than if it lacks control over the collateral in a reverse-repurchase transaction.

Control of the assets underlying a repurchase transaction exists if (*a*) the credit union holds the securities that serve as collateral for the agreement and (*b*) the credit union, upon default by the counterparty, has the ability to obtain the collateral benefit from those securities. Control may also exist if the credit union, instead of holding the securities, has the collateral held in the name of or for the benefit of the credit union by an independent third party, and condition (*b*) is met. Lack of control exposes the credit union to risk of loss of the amount invested.

b. Disclosures for repos during the period should include the following:

- The maximum amount of outstanding agreements at any month end during the period.
- The average amount of outstanding agreements for the period.
- A statement of whether the securities underlying the agreements were under the credit union's control.

4.42 Hedging Instruments. As discussed previously, the only form of hedging instrument available to federal credit unions is purchased put options on loans being sold in the secondary market. Issues Paper 86-2, *Accounting for Options*, contains several advisory conclusions of the AICPA's Accounting Standards Executive Committee. AcSEC sent the issues paper to the FASB to be considered as part of the financial instruments project. The conclusions expressed in the issues paper are advisory and not authoritative.

4.43 Options, as well as futures and forward contracts, can be used to hedge enterprises' exposures to price and interest-rate risks. Because they prescribe methods of accounting for forward contracts and futures contracts used as hedges, FASB Statement No. 52, *Foreign Currency Translation*, and FASB Statement No. 80, *Accounting for Futures Contracts*, influenced the development of the issues and AcSEC's advisory conclusions in the issues paper. The FASB has noted that certain of AcSEC's advisory conclusions conflict or are inconsistent with existing authoritative accounting pronouncements, and that the existing authoritative accounting pronouncements should be followed.

Presentation of Cash Flows

4.44 Investments are generally presented as either cash equivalents, investing activities, or operating activities in the statement of cash flows.

4.45 Cash Equivalents. A credit union should disclose its policy for determining which items are to be treated as cash equivalents. Cash equivalents are typically short-term, highly liquid investments that are (*a*) readily convertible to known amounts of cash and (*b*) so near maturity that there is insignificant risk of changes in market value because of changes in interest rates. Generally, only investments with original maturities of three months or less qualify under this definition.

4.46 Investing Activities. Cash receipts and disbursements from the purchase, maturity, and sale of investments should be presented gross. Exceptions include cash receipts and disbursements for deposits placed with other financial institutions and withdrawals of deposits, which may be presented net.

4.47 Trading Activities. Cash receipts and disbursements resulting from purchases and sales of securities should be presented as a net operating activity if those securities are acquired specifically for resale and are carried at market value in a trading account.

4.48 Hedging Activities. Cash flows resulting from a hedge transaction should be classified in the same category as the cash flows from the item being hedged.

Off-Balance-Sheet Risks

4.49 FASB Statement No. 105 requires certain disclosures of financial instruments with off-balance-sheet credit or market risk and disclosure of significant concentrations of credit risk for

all financial instruments. A discussion of these disclosure requirements is contained in chapter 5 (paragraphs 5.47 and 5.48) of this guide.

AUDIT OBJECTIVES AND PROCEDURES

Audit Objectives

4.50 The primary audit objectives for investments are to determine that—

- Securities and other investment assets exist and are either on hand or held in safekeeping or custody for the credit union.
- Securities and other investment assets include all securities and investments of the credit union, and the credit union has legal title or similar rights of ownership for all securities and investment assets.
- Consideration has been given to legal and regulatory provisions (such as restrictions on the types of securities that may be owned and requirements to dispose of certain securities) in valuing securities.
- Realized and unrealized gains and losses on the sale of securities and other investment assets and unrealized gains and losses on securities held for sale or in a trading portfolio have been properly measured, recorded, and disclosed in accordance with generally accepted accounting principles.
- Interest income on securities and other investment assets and the related statement-of-financial-condition accounts (accrued interest receivable, unearned discount, and unamortized purchase premiums or discounts) have been properly measured and recorded in accordance with generally accepted accounting principles.
- Securities and other investment assets are properly described and classified in the financial statements, and the related note disclosures are adequate.
- Mortgage derivatives are properly valued. Key assumptions made by the credit union in projecting future cash flows for mortgage derivatives have a reasonable basis, and such assumptions have been properly and accurately applied by the credit union.
- Financial instrument transactions have been captured by the credit union's accounting system, and the accounting information relating to financial instruments is complete and accurate.
- Financial instruments accounted for as hedges meet the criteria for hedge accounting, as appropriate.
- Changes in the market value of financial instruments have been appropriately measured and accounted for in the circumstances (whether or not hedge accounting is used), and the fees, premiums, commissions, and other receipts or disbursements related to financial instruments have also been appropriately accounted for.
- Disclosure of information about financial instruments in the financial statements is adequate.

Planning Considerations

4.51 The auditor should consider the factors influencing inherent risk as it relates to investments. These include management risks, operating characteristics, and portfolio characteristics.

4.52 Generally, investments are audited using a primarily substantive approach. Confirmation of investments held by outside parties or inspection of investment documents held by a credit union are efficient and effective procedures that contribute to the achievement of several audit objectives. Also, there is a high potential for management override because of management involvement in material investment transactions, and control risk is usually assessed at the maximum.

4.53 In planning the audit, the auditor should consider reading the current year's interim financial statements, investment policy, and other financial information related to investments, including mortgage-backed securities. This should include a consideration of management's policies and procedures concerning investment classification as trading assets, investment assets, or held-for-sale assets. The auditor should discuss with management these items and other current business developments affecting investments owned by the credit union. The auditor should also consider reviewing the current regulations that address the selection of securities dealers and unsuitable investment practices.

4.54 The auditor should determine whether the credit union has investments in mortgage derivatives and should obtain information (for example, offering documents or prospectuses) that describe the securities and their risk characteristics. The auditor should consider the risk characteristics of mortgage derivatives owned by the credit union. These generally include prepayment risk, interest-rate risk, and sometimes credit risk. Identification of mortgage derivatives and their related risks enables the auditor to design an appropriate audit program. Inquiry of specialists, such as investment bankers knowledgeable about mortgage-related derivatives, should be considered by the auditor if a credit union is actively engaged in holding or trading such products. In addition, the auditor should consider the volume and mix of activity and open positions in a credit union's portfolio of financial instruments. This assists in making risk assessments, designing an audit program, and performing other tests.

Internal Control Structure

4.55 Policies and Procedures. Examples of typical internal control structure policies and procedures relating to investments include the following:

- Written policy statements detailing investment guidelines, objectives, and limitations are adopted and monitored by the board of directors and designated levels of management and conform to NCUA or state regulatory guidelines, or both, regarding investment portfolio policy and accounting guidelines.
- The board of directors—generally through the investment committee—oversees management's investment activities in accordance with federal and state regulations.
- Potential investment transactions and policy changes are reviewed and approved by an investment committee and the board of directors and recorded in the minutes.
- Accounting entries supporting security transactions are periodically reviewed by supervisory personnel to ensure that the classification of investments is in accordance with the credit union's investment policy.
- Securities and other evidence of ownership are made out in the name of the credit union.
- Recorded amounts of investments are periodically compared with safekeeping ledgers, custodial confirmations, and current market values on a timely basis; differences found are investigated and resolved; appropriate supervisory personnel review and approve completed reconciliations on a timely basis.

- Authorized lists of signatures and brokers exist and are adhered to and reviewed and updated periodically.
- There is a segregation of duties among those who (*a*) approve securities transactions, (*b*) have access to securities, and (*c*) post to or reconcile investment securities records.
- Buy and sell orders to brokers are compared to brokers' advice periodically by management.
- Investments for which there is no active market are monitored for valuation at cost and are written down to market value when required.
- Unrealized gains and losses are substantiated by reconciliation of market values with carrying amounts.
- Adjustments to investment accounts are reviewed and approved by an authorized official.
- Interest and dividend income is reviewed for accuracy by reference to supporting documentation.
- MBSs held for sale are monitored for valuation at the lower of cost or market value.
- Periodically during the period, MBS valuations are obtained from outside brokers.
- Valuations for reporting purposes are reviewed for conformity with published values.
- Mortgage derivatives are monitored on an ongoing basis and factors affecting income recognition and the carrying amount of the investment are analyzed periodically to determine whether adjustments are necessary.
- The internal control structure related to off-balance-sheet financial instruments is designed to meet the objectives described previously and determine that the credit union has complied with relevant laws and regulations.
- For hedging instruments, the internal control policies and procedures address—
  - Transaction limits.
  - Accreditation of brokers.
  - Segregation of duties.
  - Reconciliations.

Tests of Controls

4.56 As mentioned earlier, the auditor usually assesses control risk for investment securities at the maximum and takes a substantive approach to the audit of investments. However, in some cases the auditor may believe control risk can be assessed below the maximum. Examples of specific procedures that the auditor should consider performing to test the operating effectiveness of internal control structure policies and procedures relating to investments include—

- Obtaining and reviewing the credit union's investment policy to ensure that approved investment activities are in compliance with federal and state regulations.
- Reviewing minutes of board of directors meetings for evidence of periodic review of investment activity to determine conformity with the credit union's investment policy.
- Comparing selected securities transactions to the credit union's investment policy to determine that the credit union is following its investment policy. The auditor should be alert and review the transactions in the securities accounts for an unusually high volume

and frequency of activity that could indicate other than a portfolio held to maturity. The auditor should also be aware that changing market conditions may necessitate deviations from the credit union's investment policy and strategies. In such cases, the auditor should determine whether management has formally documented and submitted to the board of directors reasons for any significant deviations.

- Reviewing selected securities transactions to determine whether proper approvals are obtained for the transactions and only brokers from the credit union's authorized list of brokers are used.
- Reviewing selected securities to determine that the credit union has perfected title to the investment assets (that is, all documents are in the credit union's name).
- Performing a test of the credit union's reconciliation process. The auditor should test whether reconciling differences are appropriately investigated and resolved and whether the reconciliations are reviewed and approved by appropriate supervisory personnel.

Substantive Tests

4.57 *Physical Inspection or Confirmation*. The auditor should physically inspect and count securities held on a credit union's premises at the end of the period, noting that the securities are in the credit union's name. Confirmation should be obtained of any securities pledged by or held for the credit union by a custodian.

4.58 *Valuation*. In determining whether securities are properly valued as of the financial statement date, the auditor should first evaluate management's classifications of investment securities as trading, held-for-sale, or held-to-maturity assets based on the credit union's investment policy and objectives and review of activity during the year. Evaluating the propriety of management's classification of securities as being held for investment involves a consideration of subjective matters such as management's intent to hold those securities to maturity. In conjunction with this, the auditor should test for compliance with regulatory investment directives.

4.59 The auditor should perform tests of carrying value based on the appropriate classification for these securities. For securities classified as investment assets, amortized cost should be tested by recomputation. Market values should be disclosed. Securities classified as trading-account assets should be recorded at market value and securities classified as held for sale should be recorded at the lower of aggregate cost or market value. Market values should be tested by reference to third-party market quotations.

4.60 If securities held for investment have a market value below cost, the auditor should consider the credit union's ability to recover 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. In determining whether to establish such an allowance, the auditor should refer to "Long-Term Investments: Auditing Interpretations of AU Section 332" (AICPA, *Professional Standards*, vol. 1, AU section 9332) for guidance.

4.61 *Analytical Procedures*. Analytical procedures that should be considered by the auditor include—

- Comparing current-year investment income with expected and prior-year income.
- Reviewing changes in the mix between different investment types in the portfolio.
- Assessing the reasonableness of accrued interest receivable on investments.

- Assessing the reasonableness of average yields throughout the period computed.
- Comparing current-year activity in the trading, investment, and held-for-sale accounts with expectations and the credit union's investment policy.
- For transactions accounted for as hedges, assessing the degree of correlation between financial instruments and the items they are hedging to determine whether the correlation requirement for hedge accounting has been met.

In using analytical procedures as substantive tests, the auditor should consider the amount of difference from expectations that can be accepted without further investigation. Additional guidance on the use of analytical procedures is provided by SAS No. 56.

4.62 *Other Procedures*. Other audit procedures related to investments that the auditor should consider performing include—

- Comparing investment totals in the credit union's reconciliations with the investment subsidiary ledger and the general ledger control accounts. Significant discrepancies and any large or unusual reconciling items should be investigated.
- Reading the minutes of meetings of investment committee and board of directors and testing whether transactions have been properly authorized.
- Considering evidence of impairment to the carrying amount of investments and inquiring of management and brokers regarding the reflection of such impairments in the market values.
- Determining that only approved brokers are used.
- Reviewing changes in the valuation allowance account (for investments held for sale) during the period for propriety.
- Testing gains and losses on sales of securities.
- Obtaining from management appropriate representations regarding its intent with respect to the trading and investment portfolios.

Chapter 5

LOANS

INTRODUCTION

5.1 Loans usually generate the largest portion of a credit union's revenue and represent the most significant component of its assets. In general, federal and state regulations restrict loans to credit union members only. In addition to interest income, loans may also generate other types of income such as origination fees, loan-servicing fees, late fees, and credit card fees. Because lending activities are affected by the availability of funds, credit demand, the economic environment, the field of membership, and competition, loan portfolios differ considerably among credit unions. Lending activities and the risks inherent therein are a critical aspect of a credit union's financial stability.

5.2 One of the principal risks inherent in lending is that a borrower will be unable to fulfill the terms of the obligation. This risk is referred to as *credit risk*. Credit risk may be affected by external factors such as the level of interest rates, unemployment, the rate of economic growth, trends in the local market, and the financial stability of the sponsor group. Internal factors such as underwriting practices, familiarity and experience with loan products, the relative mix and geographic concentration of the loan portfolio, and the strength of the internal control structure also have a significant effect on a credit union's credit risk. The auditor's consideration and evaluation of credit risk is discussed in chapter 6.

5.3 A credit union's credit strategy includes its defined goals and objectives for lending as well as its policies and procedures to achieve those goals and objectives. One of the primary goals of a credit strategy is to achieve profitable returns while appropriately managing and controlling the risk within the loan portfolio. Thus, a credit union may engage in a wide variety of lending activities, or it may restrict its activities to those in which it believes it has developed particular expertise or to the particular needs of its membership. The composition of a loan portfolio, therefore, is affected by the nature of a credit union and its credit strategy.

5.4 Many credit unions purchase ownership interests or financial participation interests in loans that have been originated by other financial institutions. This is a way of sharing credit risk. The seller generally continues to service the loans for a fee and remits payments to the credit union. Chapter 7 discusses loan servicing and related matters from the seller's perspective.

Types of Loans

5.5 Loans can be classified in a number of ways. The most common classifications of loans are by purpose of the loan, the type of collateral, or the method of repayment.

5.6 <u>Consumer Loans</u>. For most credit unions, the largest grouping of loans will be under the category of consumer loans. A consumer loan is a loan to an individual for household, family, or other personal expenditures. Most commonly, such loans are made to finance consumer goods, such as automobiles, boats, mobile homes, household goods, and vacations. Other types of consumer loans include student loans, home-improvement loans, loans collateralized by savings accounts, credit cards, overdraft protection, and other lines of credit. Consumer loans may be secured or unsecured.

5.7 The principal form of consumer loan is the installment loan. Installment loans are almost always made on a simple interest basis. The note is payable in installments, usually equal monthly amounts. Many consumer loans are repaid through a payroll deduction process whereby payments are automatically made on the loan when the borrower is paid. The promissory note may require monthly payments, but through payroll deduction, payments may actually be made more frequently.

5.8 *Real Estate Loans*. 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 may use underwriting guidelines that conform to those of the established secondary markets, such as the Federal National Mortgage Association, the Government National Mortgage Association, the Department of Veterans Affairs (DVA), and the Federal Home Loan Mortgage Corporation that allow credit unions to sell mortgages in the secondary market. Repayment terms customarily require monthly payments of principal and interest. Mortgage loans may be priced on either a fixed- or a variable-rate basis. The monthly payment often includes an amount to be held in escrow for the payment of real estate taxes and insurance.

5.9 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.

5.10 Real estate mortgage loans are generally 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 trust deeds).

5.11 *Business Loans*. Business loans are often made to provide working capital, to finance the purchase of inventory or equipment, and for other general business purposes. Business loans are written on a demand, time, term, or installment basis. Federally insured credit unions are restricted by NCUA regulation 701.21(h) in the amount and types of business loans they can make.

5.12 *Demand Loans*. Demand loans have no fixed maturity date, are payable on demand of the lender, and generally have floating interest rates.

5.13 *Time Loans*. Time loans are made for a specific period of time, for example, 30, 60, 90, or 180 days. Interest is payable periodically and principal is usually due at maturity. Such loans are often renewed at maturity in what is known as a *rollover*. Interest rates are fixed for the initial period and are subsequently repriced at each rollover. One variation of a time loan is a line of credit, in which the lender provides the borrower with a maximum borrowing limit for a specified period (usually one year) at a stated interest rate.

5.14 *Term Loans*. Term loans are made for a specified term in excess of one year and are either at a fixed rate or at a fixed margin over a floating rate of interest that is adjusted periodically. Repayment schedules are structured in various ways and are typically negotiated by the borrower and lender.

5.15 *Loans Held for Sale*. A credit union may originate real estate loans that it intends to sell. The credit union may be managing its interest-rate risk position by intentionally selling all the fixed-rate real estate loans it originates while retaining variable-rate real estate loans and non-real-estate fixed- and variable-rate loans.

ACCOUNTING PRINCIPLES: MEASUREMENT AND DISCLOSURE

5.16 If loans are held until maturity or payoff, they will generally be recovered at their principal balance. Therefore, they are accounted for at amortized cost: that is, outstanding principal balance plus or minus any unamortized net deferred fees or costs. If a credit union has both the ability and the intent to hold the loans for the foreseeable future or until maturity or payoff, it does not customarily recognize declines in value resulting from interest-rate fluctuations. However, an allowance for loan losses is required. Separate general ledger control accounts are normally maintained by type of loan. The control accounts are supported by subsidiary records containing all pertinent information relating to a loan.

5.17 If loans are classified as held for investment and carried at cost, documentation of the intention to originate loans for investment should be present to support this treatment.

Loan Participation, Sales, Purchases, and Servicing

5.18 Federal credit unions, as well as many state-chartered credit unions, may purchase, sell, or pledge to any source the eligible loans of its members. They may also 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, and service members' loans that have been sold to a third party. Chapter 7 and the following literature address certain aspects of loan sales:

- FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*
- FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*
- FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*
- FASB Technical Bulletin No. 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs)*
- FASB Technical Bulletin No. 87-3, *Accounting for Mortgage Servicing Fees and Rights*
- FASB EITF Consensus No. 84-21, *Sale of a Loan with a Partial Participation Retained*
- FASB EITF Consensus No. 84-30, *Sales of Loans to Special-Purpose Entities*
- FASB EITF Consensus No. 86-24, *Third-Party Establishment of Collateralized Mortgage Obligations*
- FASB EITF Consensus No. 87-30, *Sale of a Short-Term Loan Made under a Long-Term Credit Commitment*
- FASB EITF Consensus No. 88-11, *Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold*

5.19 In general, gain or loss on the sale of loans is measured by calculating the difference between the selling price and the carrying amount. Gains or losses should be recognized at the time the loans are sold. If at the end of a reporting period it is apparent that a credit union intends to sell certain loans, the loans should be reclassified and disclosed as loans held for sale and reported at the lower of cost or market value (see paragraph 7.7). See paragraphs 7.8 through 7.10 for further discussion of accounting for sales of loans.

5.20 Because of the variety of arrangements under which loan participations are purchased, it is important to consider, in addition to the stated purchase price, the terms of the purchase, the effective yield to the purchaser, and the arrangements for servicing. A premium or a discount may result when a participation is purchased 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.

5.21 The principles and guidelines set forth in FASB Statement No. 91 apply to premiums and discounts. The Statement sets forth the appropriate method of amortization and financial statement presentation and disclosure.

5.22 *Sales With Recourse*. A credit union may enter into loan sale agreements that provide recourse to the seller under certain conditions. For example, the seller may be obligated to make full or partial payment to the purchaser if the debtor fails to pay when payment is due. Similarly, payments by the seller under recourse provisions may be required due to the effect of loan prepayments, or for adjustments resulting from defects of the transferred loans (for example, when the security interest in the collateral is not appropriately perfected). In some cases (for example, student loans), underwriting exceptions identified subsequent to the sale of loans may subject the originating credit union to additional recourse risk if the borrower defaults on the loan. FASB Statement No. 77 provides authoritative standards on accounting for sales of loans with recourse provisions. In general, FASB Statement No. 77 provides that a transfer of loans with recourse should be recognized as a sale only if all of the following conditions are met:

- The transferor surrenders control of the future economic benefits embodied in the loans.
- The transferor's obligation under the recourse provisions can be reasonably estimated.
- The transferee cannot require the transferor to repurchase the loans except pursuant to the recourse provisions.

5.23 If a transfer qualifies to be recognized as a sale, all probable adjustments in connection with the recourse obligations to the transferor should be accrued in accordance with FASB Statement No. 5, *Accounting for Contingencies*. If a transfer does not qualify to be recognized as a sale, the cash received in the transaction is treated as a secured borrowing.

5.24 *Troubled-Debt Restructurings*. The provisions of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, are required to be applied when accounting for troubled-debt restructurings.

5.25 FASB Statement No. 15 requires that a modification of terms of a loan receivable be accounted for prospectively and not as a change in the recorded investment in the receivable unless total future cash payments, as specified by the new terms, are less than the recorded investment. The excess of future cash receipts specified by a modification, including both receipts designated as interest and receipts designated as principal, over the recorded investment in the receivable is recognized as interest income over the life of the restructured agreement using the interest method. If the future cash receipts specified by the new terms are less than the recorded investment in the receivable, the recorded investment in the receivable should be reduced to an amount equal to the future cash receipts specified. The amount of reduction should be recognized as a loss. At the time of the restructuring and periodically thereafter, the recorded investment in the receivable should be evaluated and an allowance for loss should be recognized, if necessary, as required by FASB Statement No. 5. Chapter 6 provides a further discussion of these matters.

5.26 AICPA Practice Bulletin No. 7 notes that paragraph 34 of FASB Statement No. 15 addresses troubled-debt restructurings that are in-substance repossessions or foreclosures by the creditor and requires loss recognition based on the fair value of the collateral that is in-substance foreclosed. Although paragraph 84 of FASB Statement No. 15 requires accounting for a transfer of assets if the creditor obtains control or ownership (or substantially all of the benefits and risks incident to ownership) of one or more assets of the debtor and the debtor is wholly or partially relieved of the obligation under the debt, it does not give explicit criteria for determining whether collateral for a loan has been in-substance foreclosed. Collateral that has been in-substance foreclosed should be reported in financial statements in the same way as collateral that has been formally repossessed, regardless of whether the related loan is formally restructured.

5.27 If it is probable that a creditor will not collect all the promised payments on a collateralized loan, the creditor should determine whether the collateral has been in-substance foreclosed. That determination should be made before determining the loan-loss allowance, because if a creditor determines that the collateral has been in-substance foreclosed, the reporting of the asset should change from that of a loan receivable to that of another asset—the collateral.

5.28 *Criteria*. A creditor should consider collateral for a loan in-substance foreclosed if all the following criteria are met:

a. The debtor has little or no equity in the collateral, considering the current fair value[15] of the collateral.

b. Proceeds for repayment of the loan can be expected to come only from the operation or sale of the collateral.

c. The debtor has either (*1*) formally or effectively abandoned control of the collateral to the creditor, or (*2*) retained control of the collateral but, because of the current financial condition of the debtor, or the economic prospects for the debtor or the collateral, or both, in the foreseeable future, it is doubtful that the debtor will be able to rebuild equity in the collateral or otherwise repay the loan in the foreseeable future.

5.29 *Financial Reporting*. If all the criteria in paragraph 5.28 are met, the collateral for the loan has been in-substance foreclosed and the reporting should reflect that determination in conformity with paragraph 34 of FASB Statement No. 15: That is, such a loan should be reported in the same way as a creditor would report the receipt of collateral in satisfaction of a loan receivable. Such a loan should be reclassified to the category or categories of the collateral, and the recorded investment in the loan should be reduced to the fair value of the collateral, which establishes a new cost basis in the same manner as a legal foreclosure. The excess of the recorded investment in the loan receivable over the fair value of the collateral should be recognized as a loan loss in the current period to the extent that it is not offset against previously established allowances for uncollectible amounts or other valuation accounts.

5.30 If the conditions that led to the conclusion that collateral for a loan has been in-substance foreclosed change, and the criteria for in-substance foreclosure in paragraph 5.28 are clearly no longer met, the subsequent reporting should be as follows: The collateral should be reclassified to a loan receivable and the probable estimated future cash receipts in excess of the carrying

[15] *Fair value* is defined in paragraph 13 of FASB Statement No. 15 as "the amount that the debtor could reasonably expect to receive . . . in a current sale between a willing buyer and a willing seller, that is, other than a forced or liquidation sale." The AICPA's *Guide for the Use of Real Estate Appraisal Information* provides guidance on evaluating appraisals of real estate used to determine fair value.

amount of the asset should be amortized as interest revenue over the remaining life of the loan, even if the effect is to recognize an unusually high effective interest rate.

5.31 Such reporting is consistent with the answer to the question addressed in FASB Technical Bulletin 79-7, *Recoveries of a Previous Writedown under a Troubled Debt Restructuring Involving a Modification of Terms,* which states that the amount of the direct writedown should not be reversed.

5.32 Practice Bulletin No. 7 notes that the Accounting Standards Executive Committee expects that the applicability of paragraph 5.30 would be rare. A formal modification of terms of the underlying loan would not, by itself, result in reversal of the in-substance foreclosure. Market conditions would have to improve substantially or the debtor would have to rebuild equity in the collateral by a substantial investment not financed by the lender.

5.33 Meeting the Criteria. In evaluating whether the first two criteria are met, a creditor should consider the guidance on accounting for real estate acquisition, development, or construction (ADC) arrangements in the AICPA's February 10, 1986, Notice to Practitioners, *ADC Arrangements*, which is reprinted as exhibit 1 of Practice Bulletin No. 1, *Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance*. That Notice provides guidance for determining whether ADC arrangements should be reported as loans, investments in real estate, or investments in joint ventures that is analogous to determining whether collateral for a loan has been in-substance foreclosed. If the characteristics listed in paragraph 8 of that Notice exist, the first two criteria in paragraph 5.28 likely will be met.

5.34 The second criterion in paragraph 5.28 may always be met for certain loans. For example, creditors underwrite certain nonrecourse loans with the expectation that the loans will be serviced solely from cash flows from the operation, and sometimes sale, of the collateral. Nevertheless, if the loans meet both the first and third criteria in paragraph 5.28, the collateral should be considered to have been in-substance foreclosed.

5.35 The issue of whether a debtor can rebuild equity in collateral or repay the loan in the foreseeable future is in the third criterion in paragraph 5.28. Part *b* of that criterion is met unless a creditor has evidence that it is probable that the debtor will be able to build or rebuild equity in the collateral in the foreseeable future.

5.36 In evaluating part *b* of the third criterion, a creditor should, if possible, consider the tax aspects of certain transactions when evaluating a debtor's commitment to the collateral. For example, a debtor appearing to have little equity in the collateral may have incentive to avoid foreclosure if an ownership change would produce a substantial negative tax effect for the debtor. However, a creditor must have evidence that it is probable that, because of the negative tax effect, the debtor will repay the loan in the foreseeable future.

5.37 If a creditor determines that estimated cash receipts from the operation or sale of the collateral would be insufficient to service the remaining balance of the loan, the creditor may analyze secondary sources, such as guarantees. However, amounts that would be collected from such secondary sources are difficult to estimate, because the substance of the guarantee and the ability of the guarantor to perform can be difficult to evaluate.[16]

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[16] Paragraphs 10 through 14 of the AICPA's Notice to Practitioners, *ADC Arrangements*, reprinted in the AICPA's Practice Bulletin No. 1, provide guidance on evaluating guarantees.

5.38 If assets are acquired in full satisfaction of a receivable, FASB Statement No. 15 requires that such assets be accounted for at their fair value at the time of the restructuring. Any excess of the recorded investment in the loan receivable satisfied over the fair value of such assets received should be recognized as a loan loss in the current period to the extent that it is not offset against previously established allowances for uncollectible amounts or other valuation accounts. The fair value of the assets acquired becomes their cost basis for accounting purposes at the date of the restructuring.[17] Subsequent to a troubled-debt restructuring, real estate acquired should be accounted for in the same manner as real estate purchased for cash, that is, at the lower of cost or estimated net realizable value.

Allowance for Loan Losses

5.39 Management is responsible for maintaining an adequate allowance for loan losses applicable to all categories of loans. Chapter 6 discusses the accounting and auditing considerations related to the allowance for loan losses.

Interest Income

5.40 Interest is accrued and credited to interest income as it is earned using the interest method. The accrual of interest income should be discontinued, and previously accrued interest should be reversed, when it is determined that collection of accrued interest or any amount of principal is doubtful. Collectibility of accrued interest should generally be determined by evaluating the ability to recover accrued interest from the borrower. If amounts are received on a loan on which the accrual of interest has been discontinued, a determination should be made about whether the payment received should be recorded as a reduction of the principal balance or as interest income. If the ultimate collectibility of principal, whether in whole or in part, is in doubt, any payment received on a loan on which the accrual of interest has been discontinued should be applied to reduce principal to the extent necessary to eliminate such doubt. For construction loans, in which interest is often paid during the construction period from loan proceeds, the credit union should periodically assess the net realizable value of the underlying collateral on these arrangements to ensure that interest is not capitalized in excess of the amount that can be realized from the sale of the project. The auditor should be aware that the NCUA requires that loans three months or more delinquent be placed on nonaccrual status. Accruals of interest on loans should be reversed when the loan is determined to be a loss or when it becomes twelve months delinquent, whichever occurs first. This may be in conflict with GAAP. State regulators may also have specific requirements for the discontinuance and reversal of accrued income.

Loan Fees and Costs

5.41 In addition to interest income on loans, the lending process results in other sources of income and expense such as loan-origination, commitment, and credit card fees and costs. In general, FASB Statement No. 91 requires that loan fees, net of direct loan origination costs, be deferred and amortized as an adjustment of yield over the contractual life of the loan (unless prepayments can be estimated pursuant to FASB Statement No. 91, in which case the effect of prepayments may be considered). As defined by FASB Statement No. 91, direct loan-origination costs include incremental direct costs incurred in transactions with third parties and certain costs directly related to specified activities performed by the lender. Deferred costs include only the

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[17] Accounting for foreclosed assets is diverse in practice. In December 1990, the AICPA Accounting Standards Executive Committee issued an exposure draft of a statement of position on accounting for foreclosed assets. The proposed SOP would amend this guide and eliminate the diversity in practice. Readers should be alert for the issuance of final guidance on accounting for foreclosed assets.

direct costs of completed loans and must be deferred irrespective of the existence of related loan fees. Direct costs of unsuccessful loans and all indirect costs are charged to expense as incurred. Credit card fees should be amortized over the period the fee entitles the cardholder to use the card.

5.42 *Purchased Loans*. FASB Statement No. 91 distinguishes between the origination of loans and the purchase of loans. In the purchase of loans, the initial investment includes only the amount paid to the seller, plus any fees paid, less any fees received. All other costs related to the purchase of loans are charged to expense as incurred. Premiums and discounts on purchased loans are recognized as an adjustment of yield over the contractual life of the loan, unless prepayments can be estimated pursuant to FASB Statement No. 91, in which case the effect of the prepayments may be considered. AICPA Practice Bulletin No. 6, *Amortization of Discounts on Certain Acquired Loans*, provides guidance on the amortization of discounts on certain acquired loans for which there is uncertainty as to the amounts or timing of future cash flows.

5.43 *Refinancings or Restructurings*. FASB Statement No. 91 requires that the accounting for net fees or costs related to refinancings or restructurings be based on whether the terms of the new loan represent more than minor modifications and are at least as favorable to the lender (based on effective yield) as the terms of comparable loans.

5.44 FASB Statement No. 91 requires the amortization of net fees or costs, as well as purchase premiums and discounts on all interest-earning assets, as yield adjustments, using the interest method. Prepayments are not anticipated in the application of the interest method unless the credit union holds a large number of similar loans for which prepayments are probable and the timing and amounts of prepayments can be reasonably estimated.[18] FASB Statement No. 91 also provides guidance on the application of the interest method to variable-rate loans and indicates that amortization of net deferred loan fees should be discontinued for nonperforming loans.

5.45 FASB Statement No. 91 establishes authoritative standards for loans with no scheduled payment terms (demand loans) and revolving lines of credit. In general, net deferred fees and costs on demand loans are recognized on a straight-line basis, over a period (*a*) consistent with the credit union's understanding with the borrower or (*b*) if no understanding exists, the credit union's estimate of the period over which the loan will remain outstanding. Fees and costs on revolving lines of credit are recognized in income on a straight-line basis over the period the revolving line of credit is active, assuming that borrowings are outstanding for the maximum term provided in the loan contract.

Financial Statement Presentation

5.46 Loans are normally presented separately in the statement of financial condition in an aggregate amount. The allowance for loan losses and net unamortized deferred fees or costs should be presented separately in a note, unless it is presented separately on the face of the statement of financial condition. Loans held for sale are presented separately on the face of the statement of financial condition and should be reported at the lower of cost or market value.

5.47 Note disclosures should include a classification of loans by major types of lending, for example: (*a*) consumer installment loans, (*b*) real estate loans, and (*c*) business loans. Other loan categories should also be presented if they are necessary to reflect any unusual risk concentration.

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[18] See footnote 3.

In addition, the amount of loans on a nonaccrual basis, including loans accruing at a reduced rate and the income statement effect of nonaccrual loans, should be disclosed if they are material. The dollar amount of outstanding commitments—for example, undisbursed lines of credit, unused credit card lines, and loans in process—should also be disclosed.

5.48 FASB Statement No. 105 indicates that group concentrations of risk exist if a number of counterparties are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. It prescribes the following disclosure for each significant concentration of credit risk:

a. Information about the activity, region, or economic characteristic that identifies the concentration

b. The amount of the accounting loss attributed to credit risk the credit union would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the credit union

c. The credit union's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the credit union's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

5.49 FASB Statement No. 105 also requires disclosure of the following information about the extent, nature, and terms of financial instruments with off-balance-sheet risk by class of financial instrument. Items *a* and *b* of this paragraph are disclosed for financial instruments with off-balance-sheet market or credit risk, and items *c* and *d* are disclosed for financial instruments with off-balance-sheet credit risk:

a. The face or contract amount (or notional principal amount if there is no face or contract amount)

b. The nature and terms, including, at a minimum, a discussion of (*1*) the credit and market risk of those instruments, (*2*) the cash requirements of those instruments, and (*3*) the related accounting policy pursuant to the requirements of APB Opinion No. 22, *Disclosure of Accounting Policies*

c. The amount of accounting loss due to the credit risk the credit union would incur if any party to the financial instrument failed completely to perform according to the terms of the contract and the collateral or other security, if any, for the amount due proved to be of no value to the credit union

d. The credit union's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the credit union's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

Examples of financial instruments with off-balance-sheet risk are loans sold with recourse (with or without a floating interest rate provision), fixed-rate and variable-rate loan commitments, financial guarantees, and letters of credit (see appendix B to FASB Statement No. 105).

5.50 Credit unions also make loans to directors and officers in the normal course of business and subject to certain regulatory restrictions. If significant, the aggregate amount of such loans should be disclosed. Disclosure should also be made if evidence indicates that significant amounts of

such loans were made at other-than-ordinary terms. See paragraph 5.56 for additional guidance. FASB Statement No. 57, *Related Party Disclosures*, provides additional guidance on related-party transactions.

5.51 Commitments to originate loans in the ordinary course of business and to purchase or sell loans generally have no immediate accounting effect when evaluating the allowance for loan losses; however, they should be disclosed in the notes to the financial statements in accordance with FASB Statement No. 105, as discussed in paragraph 5.49. The auditor should consider such commitments when evaluating whether an allowance or a liability for losses related to off-balance-sheet financial instruments is necessary. Consideration should also be given to disclosing commitments to lend additional funds to debtors whose loans are nonperforming. The total carrying value of loans pledged as collateral should also be disclosed.

5.52 For outstanding loans the terms of which have been modified in troubled debt restructurings,[19] the following should be disclosed by major categories of receivables, regardless of when the restructuring occurred:[20] (*a*) the aggregate recorded investment; (*b*) the gross interest income that would have been recognized in the current period if those receivables had been current in accordance with their original terms, and if they had been outstanding throughout the period or since origination, if they were held for part of the period; and (*c*) the amount of interest income on those receivables that was included in the income for the current period. The amount of commitments, if any, to lend additional funds to debtors owing receivables whose terms have been modified in troubled-debt restructurings should also be disclosed.

5.53 The summary of significant accounting policies should include—

- The basis of accounting for loans held in the portfolio.
- The method used to recognize loan losses.
- The method for recognizing interest income on loans, including the policy for discontinuing accrual of interest on nonperforming loans; the treatment of loan fees and costs, including the method of amortizing net deferred fees or costs; and the policy for discontinuing the amortization of deferred loan fees on nonperforming loans.

AUDIT OBJECTIVES AND PROCEDURES

Audit Objectives

5.54 The primary audit objectives for loans are to determine that—

- Loans exist and are owned by the credit union as of the date of the financial statements.
- The allowance for loan losses is adequate for estimated losses inherent in the loan portfolio.

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[19] A receivable the terms of which have been modified need not be included in this disclosure if, subsequent to the restructuring, its effective interest rate has been equal to or greater than the rate that the creditor was willing to accept for a new receivable with comparable risk.

[20] These disclosures are not required for real estate loans secured by one- to four-family residential properties or loans to individuals for household, family, and other personal expenditures.

- Interest income and the related statement-of-financial-condition accounts (accrued interest receivable and unamortized net deferred loan fees or costs) have been properly measured and recorded.
- Gains and losses on the sale of loans have been measured and recorded properly.
- Loans are properly described and classified in the financial statements in accordance with generally accepted accounting principles and related note disclosures are adequate.

Planning Considerations

5.55 The auditor should consider the factors influencing inherent risk as it relates to loans receivable. These include management risks, operating characteristics, and portfolio characteristics.

Internal Control Structure

5.56 During planning, the auditor should obtain knowledge about the internal control structure policies and procedures that relate to loans receivable, applying loan payments, and accruing interest. That knowledge should include an understanding of the credit union's lending policies and procedures in order to understand the environment within which lending activity takes place. The existence of a well-defined lending policy as part of an effective internal control structure is essential for maintaining the quality and safety of assets and for ensuring the reliability of the financial records. Control environment factors that should be considered include—

- The existence of a formal written lending policy outlining the scope and allocation of the credit union's credit facilities.
- A formalized lending-approval system.
- Established credit limits.
- Limits and controls over the types of loans made, collateral, and geographic location.
- Maturity limits and policies on interest rates that are charged.
- A formalized reporting system that provides the credit union with the information needed to manage the loan portfolio and make business decisions.

5.57 In planning the audit, the auditor should also obtain an understanding of the accounting system and control procedures relating to lending activities. Typical internal control structure policies and procedures relating to loans include the following:

- Appropriate officers or committees approve all loans and credit lines (including all new loans, renewals, and extensions) in conformity with formal lending policies and authority limits.
- Approvals are based on credit investigations and evaluations performed prior to extending the credit.
- An inventory of required loan documents, including evidence of collateral and of the recording of liens, is monitored to ensure timely receipt and comparison to the appropriate file.
- Pertinent loan information entered into the data-processing system—for example, loan type, loan amount, interest rate, maturity, amortization terms, and collateral—is independently tested to ensure accuracy.

- Subsidiary ledgers and trial balances are maintained and reconciled to the general ledger on a timely basis, differences found are investigated and resolved, appropriate supervisory personnel review and approve completed reconciliations on a timely basis.
- Payments due for principal or interest are monitored for their eventual receipt, aging of delinquencies, and follow-up with late payers.
- There is a segregation of duties among those who (*a*) approve loans, (*b*) control notes and collateral, (*c*) receive payments, and (*d*) post or reconcile subsidiary ledgers.
- Outstanding loans and the related accrued interest receivable are periodically reviewed for collectibility and adequacy of collateral, based on detailed, timely credit investigations and evaluations.
- Appropriate personnel periodically review collateral valuation. Where appropriate, an institution should monitor the existence and adequacy of insurance coverage to safeguard pledged collateral.
- Procedures are periodically performed to ensure that interest income is properly accrued and recorded.
- Notes and collateral on hand are kept in secure, locked, fireproof compartments. Negotiable collateral is kept under dual access control.
- Construction loan advances are documented and periodic on-site inspections of the properties are performed.

Tests of Controls

5.58 Examples of specific procedures the auditor should consider performing to test the operating effectiveness of internal control policies and procedures for loans include—

- Inspecting loan documents to determine whether the credit union's underwriting policies and procedures are being followed—for example, to test whether loans are being approved by authorized officers or committees in accordance with lending policies, whether credit investigations are performed, whether the procedure to capture all required loan documents is functioning, and whether the information recorded in the data-processing system and used for management reporting is being independently tested and is accurate. (This test can also be a substantive test in that it provides evidence of the existence of loans and the accuracy of loan balances.)
- Testing the reconciliation process. This might include the daily activity-balancing process as well as the reconciliation of subsidiary ledgers to the general ledger. The auditor should test whether reconciling differences are appropriately investigated and resolved and whether the reconciliations are reviewed and approved by appropriate supervisory personnel.
- Testing the accuracy and performing a review of reports detailing loans to one borrower and related-party loans.

5.59 The auditor should obtain and read the current year's interim financial statements and other financial information. This might include information about such items as dollar amounts and types of loans, the volume of new loans and related net deferred loan fees or costs, and delinquency. The auditor should discuss with management these items and other current business developments affecting the credit union.

Substantive Tests

5.60 _Subsidiary Records_. The auditor should generally obtain and check the arithmetical accuracy of detail schedules of loan principal balances and related accounts (for example, accrued interest receivable, and net deferred loan fees and costs), agree beginning balance amounts in detail schedules with beginning balances in the financial statements, and reconcile ending balances to the trial balance, general ledger, and subsidiary records. The auditor should determine the propriety of significant reconciling items.

5.61 _Analytical Procedures_. Analytical procedures that the auditor may apply in the loan receivable area include—

- Reviewing changes in the mix among different loan types in the portfolio.
- Comparing new loan volume by month with volume of prior periods.
- Comparing current-year income with expectations and prior-year income.
- Comparing yields on loans with the credit union's established lending rates or pricing policies.
- Reviewing statement-of-financial-condition accruals for reasonableness.
- Computing average yield throughout the period for each loan category on a monthly or quarterly basis.
- Considering any other relevant relationships.

5.62 In using analytical procedures as a substantive test, the auditor should consider the implications of changes in important relationships and the amount of a difference from expectations that can be accepted without further investigation. For example, a significant increase in loan-origination volume near the end of the period that exceeds expectations may indicate a deterioration in loan quality. SAS No. 56 provides guidance on the use of analytical procedures and requires the use of analytical procedures in the planning and overall review stages of all audits.

5.63 _Inspection of Loan Documents_. Loan files vary significantly in content depending on the type of loan. Inspection of loan documents provides evidence about the existence of loans. The extent of documentation reviewed by the auditor is a matter of judgment. A test of the files supporting old loans (loans made before the period covered by the current audit), as well as new loans (including some of the loans still in the process of disbursement), is generally needed to obtain an understanding of the internal control structure policies and procedures sufficient to plan substantive tests. All of the documents relating to a particular loan usually are filed together in a separate folder. When performing a loan document inspection, the auditor should be alert to notation or other indications of problems that merit further investigation or follow-up. When loan documents are in the possession of an attorney or other outside parties, the auditor should consider confirming the existence and ownership of such documents.

5.64 _Real estate loans_—The extent of documentation supporting real estate mortgage loans depends in part on the requirements of local law. The basic documents generally include, but are not necessarily limited to, the note, loan application, credit information, appraisal report, deed of trust or mortgage, title insurance or opinion, hazard insurance policy, settlement statement, and DVA guarantee or Federal Housing Administration (FHA) insurance, if applicable.

5.65 The NCUA's *Credit Manual for Federal Credit Unions* recommends that each real estate file contain at a minimum—

- A loan application that reveals the amount of credit requested, the purpose of the credit, and the applicant's signature.
- The signature and approval notation of the credit committee or 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 (see NCUA *Rules and Regulations*, part 7.22).
- Evidence of clear title from a title insurance policy or an attorney's 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.

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

5.67 *Business loans*—The principal support for all types of loans is the signed note. For business loans, a credit file is commonly maintained. This file usually contains the borrower's business or personal financial statements, or both; memoranda regarding communications with the borrower; financial statements of guarantors; copies of supplemental agreements between the credit union and the borrower; and other loan-related correspondence. The timely receipt and review of these documents provides a basis for extending credit and maintaining an awareness of loan status. Collateral records are also typically maintained, either as part of the detail loan record or in separate files, indicating the current status of pledged collateral.

5.68 *Consumer loans*—Files supporting consumer installment loans generally include at a minimum—

- A completed loan application that includes references and is signed by the applicant.
- A credit report and credit analysis, including the verification of income.
- Perfected lien documentation if the loan is secured. This could include a certificate of title showing the credit union as lienholder or a security agreement filed with the proper state agency.
- Insurance on the collateral naming the credit union as the loss payee.

5.69 The inspection of loan documents should also include tests of approvals by loan officers or the credit committee, tests of evidence (such as stamped loan documents) that mortgage documents have been entered on the public record, a comparison of loan amounts with appraisals, and a review of the adequacy of hazard and title coverage. Loans generated under certain governmental programs and other special arrangements may require the auditor to review the specific trust or servicing agreements to determine whether additional audit procedures may be required under such arrangements.

5.70 *Construction loans*—Auditing procedures should be adapted to the credit union's construction-lending practices. The auditor should review the policies and procedures pertaining to construction loans, including classification and accounting treatment. The auditor should consider making tests of origination, approval, inspection, and disbursement procedures. As construction progresses, requests are made by the builder for disbursement of portions of the loan proceeds. The project should be inspected by the credit union to determine that construction has progressed to the point permitting the disbursements requested. The builder generally obtains waivers of lien from subcontractors and materials suppliers before disbursements are made by the credit union. If construction-disbursement controls are not considered effective, the auditor may wish to visit selected construction sites to evaluate the progress on the project.

5.71 *Confirmation of Loans*. SAS No. 67, *The Confirmation Process*, provides guidance about the confirmation process in audits performed in accordance with GAAS. SAS No. 67 states that confirmation of accounts receivables (including a financial institution's loans) is a generally accepted auditing procedure. As such, SAS No. 67 states that there is a presumption that the auditor will request the confirmation of accounts receivable unless one of the following is true:

a. Accounts receivable are immaterial to the financial statements.

b. The use of confirmation would be ineffective. For example, if, based on prior years' audit experience or on experience with similar engagements, the auditor concludes that response rates to properly designed confirmation requests will be inadequate, or if responses are known or expected to be unreliable, the auditor may determine that the use of confirmations would be ineffective.

c. The auditor's combined assessed level of inherent and control risk is low, and the assessed level, in conjunction with the evidence expected to be provided by analytical procedures or other substantive tests of details, is sufficient to reduce audit risk to an acceptably low level for the applicable financial statement assertions. In many situations, both confirmation of accounts receivable and other substantive rests of details are necessary to reduce audit risk to an acceptably low level for the applicable financial statement assertions.

5.72 Generally, confirmation of loan balances and related information, including loan purchases and sales, is an effective way to gather evidence with respect to ownership, existence, and accuracy of the recorded loan balances of a credit union. Thus, the auditor of the financial statements of a credit union should request confirmation of selected loan balances directly from the borrower. SAS No. 67 requires auditors who do not request confirmations to document how they overcame the presumption that confirmations will be requested.

5.73 In designing confirmation requests, the auditor should consider the types of information respondents will be readily able to confirm, since the nature of the information being confirmed may directly affect the competence of the evidence obtained as well as the response rate. For example, respondents may not be able to confirm the balances of installment loans, but they may be able to confirm whether their payments are up-to-date, the amount of the payment, the interest rate, and the term of their loans.

5.74 Auditors of financial statements of credit unions may use either positive or negative forms of confirmation requests to confirm loans. Negative forms may be used when (*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. Auditors should consider performing other substantive procedures to supplement the use of negative confirmations. Positive confirmation procedures should be used

for larger loans and for loans that require additional assurance or other related information in addition to the loan balance, such as amount and type of collateral.

5.75 Auditors often use audit sampling in performing confirmation test work. SAS No. 39, *Audit Sampling*, provides guidance for planning, performing, and evaluating audit samples.

5.76 *Accrued Interest Receivable and Interest Income*. The auditor should consider using computer-assisted audit techniques to recalculate accrued interest receivable. Alternatively, it may be necessary to manually test accrued amounts of individual accounts. In some cases, accrued interest receivable may be tested effectively through the use of analytical procedures (for example, comparison of current-year balance with comparable prior-year balance). Interest income can often be examined effectively by using monthly analytical tests by type of loan. The auditor should consider average balances in principal accounts, related yields as compared to rates offered and rates on existing loans, and other factors and relationships. Average rates may be obtained by using client-computerized records that should be tested for accuracy, or estimated by referring to a summary of loans by interest rate or some other reasonable method.

5.77 Computer-assisted audit techniques may also be used to perform "exception/limit" checks of individual files for unusual or questionable items meriting further investigation. Examples include identifying unusual interest rates, balances, and payments, or testing the accuracy of the credit union's delinquency report.

5.78 *Whole Loans or Participations Purchased*. Audit procedures for purchased loans should be similar to those for direct loans, except that requests for confirmation of balances, collateral, and recourse provisions, if any, are usually sent to the originating or servicing institution. The auditor should consider confirming the actual status of borrower payments with the servicer. Although it is usually not practicable to confirm balances of serviced loans with the individual borrowers, the servicer's independent auditor often performs audit procedures on individual loans, such as confirmation with borrowers and examination of loan documents. Paragraph 17 of SAS No. 70,* *Reports on the Processing of Transactions by Service Organizations*, provides guidance on audit evidence that auditors may obtain through the involvement of service auditors engaged to perform procedures that are substantive in nature. Chapter 7 provides additional guidance on servicing arrangements.

5.79 *Whole Loans or Participations Sold*. Details of loans sold should be confirmed with participating institutions, including the balances of their investments, percentage of ownership, the basis on which loans have been sold (recourse or nonrecourse), and the existence of any oral commitments such as guarantees or agreements to repurchase. The auditor should consider reviewing activity, testing the mathematical accuracy of selected remittance reports, and reviewing related agreements, contracts, and other pertinent documentation for compliance with key provisions.

5.80 The auditor should consider confirming with participating institutions that loans sold by the credit union are not subject to any credit guarantees or other side agreements. The gain or loss on selected sales (for example, large or unusual or both) during the period should be recalculated, including the recognition of a normal servicing fee in accordance with FASB Statement No. 65 and FASB Technical Bulletin No. 87-3.

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* **Note:** SAS No. 70 was being prepared for publication at the time this exposure draft was issued. It is expected to be available in mid- to late April.

5.81 *Loan Classification*. The auditor should consider whether or not any portion of the credit union's loans is being held for sale and, if so, whether or not a corresponding writedown to lower of cost or market value is necessary. In evaluating whether loans are held for sale or investment, the auditor should consider management policy and practices (for example, previous loan sale activity, types of loans sold, transactions subsequent to year end, and pending contracts) and whether management has the ability and intent to hold the loans for the foreseeable future or until maturity.

5.82 *Loan Fees and Costs*. The auditor should review and test the propriety of deferred loan origination fees and costs in accordance with FASB Statement No. 91. The auditor should also test the amortization or accretion of net deferred loan fees or costs.

5.83 *Financial Statement Presentation*. The auditor should review the propriety and adequacy of the financial statement presentation and disclosure of loans receivable.

Regulatory Restrictions

5.84 Regulatory authorities impose numerous restrictions on loans. The restrictions include, but are not limited to, loan-to-value limits, limits on loans to one borrower, maximum lending limits, and limits on loans to officers, directors, and employees. Additional limitations are often adopted by a credit union's board of directors. The auditor should be generally familiar with lending rules and supervisory regulations and policies, and discuss apparent noncompliance with management. Reference should be made to the guidance in SAS No. 54 if the auditor becomes aware of any apparent violations of laws or regulations.

Chapter 6

ALLOWANCE FOR LOAN LOSSES

INTRODUCTION

6.1 Credit unions are required to maintain an adequate allowance for loan losses (allowance). Management is responsible for the timely and periodic determination of the amount of the allowance required. The allowance is an estimate and requires substantial judgment. The independent auditor should obtain reasonable assurance that management, based on all available and relevant information affecting the loan portfolio,[21] has provided an adequate allowance.

6.2 Federal credit unions are required to establish and maintain an allowance for loan losses account by part 702 of the NCUA *Rules and Regulations*. Federally insured state-chartered credit unions are usually required by their insurance agreement with the National Credit Union Share Insurance Fund to establish and maintain an allowance account. The requirements for state-chartered credit unions that are not federally insured vary by state and insurer.

ACCOUNTING PRINCIPLES: MEASUREMENT AND DISCLOSURE

6.3 FASB Statement No. 5 is the primary authoritative standard on the accounting and reporting of loss contingencies, including loan losses. In accordance with FASB Statement No. 5, an estimated loss from a loss contingency should be accrued by a charge to income if both of the following conditions are met:

a. Information available prior to issuance of the financial statements indicates that it is *probable that an asset had been impaired or a liability had been incurred at the date of* the financial statements.

b. The amount of the loss can be reasonably estimated.

6.4 The allowance for loan losses should, therefore, be adequate to cover specifically identified loans, as well as estimated losses inherent in the loan portfolio, such as loans and pools of loans for which losses are probable but not identifiable on a specific loan-by-loan basis.

6.5 Arriving at an appropriate allowance for loan losses necessarily involves a high degree of judgment on the part of a credit union's management. Because the allowance and the related provision for losses are key elements of the financial statements, it is critical that those judgments are exercised in a disciplined manner that is based on detailed analyses of the loan portfolio. Generally, a credit union should employ a systematic methodology each period to determine the amount of loan losses to be reported, and should document the rationale supporting each period's determination.

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[21] The term *loan portfolio* refers primarily to loans, leases, and commitments to lend. In addition, credit unions are offering new financial products that contain elements of credit risk, and normally management considers including the credit risk associated with these new financial products when determining the adequacy of the allowance for loan losses. Although the auditor's evaluation of the allowance for loan losses should include an evaluation of off-balance-sheet financial instruments, it should be noted that consistent with paragraph 92 of FASB Statement No. 105, the nature and amount of allowances or liabilities for losses related to off-balance-sheet financial instruments should be reported separately.

6.6 The allowance for loan losses account is increased by charges to current period operations when the account balance is deemed insufficient to provide for probable losses. The account is also increased by amounts recovered on charged-off loans. The account is decreased by the amount of loans approved by the board of directors for chargeoff. The account may also be decreased in the unusual circumstance that it is determined that the balance is larger than necessary.

6.7 It is management's responsibility to maintain an adequate allowance for loan losses applicable to all categories of loans through periodic charges to operating expenses. The reasonableness of the allowance should be judged by considering the adequacy of the allowance, not the provision charged against income. Loans should be charged off against that allowance in the period in which the loans or portions thereof are determined to be uncollectible.

6.8 Allowance for loan losses on specifically identified doubtful or troubled loans collateralized by real estate should be based on the estimated net realizable value of the underlying collateral,[22] unless the criteria for in-substance foreclosure in Practice Bulletin No. 7 have been met. The auditor should refer to chapter 5 for guidance on the appropriate accounting for in-substance foreclosed assets, including a writedown to fair value[23] and reclassification in the statement of financial condition. As set forth in FASB Technical Bulletin 79-6, *Valuation Allowances Following Debt Restructuring*, and FASB EITF Consensus No. 87-5, *Troubled Debt Restructurings: Interrelationship between FASB Statement No. 15 and the AICPA Savings and Loan Guide*, FASB Statement No. 5 applies to the allowance for loan losses on loans that are or have been the subject of restructurings as well as to other loans. The consensus reiterated that credit unions must account for a troubled-debt restructuring in accordance with FASB Statement No. 15 and must continually assess the collectibility of the resulting receivable as required by FASB Statement No. 5.

6.9 Collateral on identified doubtful or troubled loans should be considered repossessed in substance, classified as other real estate owned, and accounted for at fair value, consistent with repossession accounting as described in FASB Statement No. 15, when all the following criteria are met:

- The debtor has little or no equity in the collateral, considering the current fair value of the collateral.
- Proceeds for repayment of the loan can be expected to come only from the operation or sale of the collateral.

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[22] The term *estimated net realizable value* means the estimated sales price in cash or cash equivalents on subsequent disposition reduced by the sum of the following estimates: (*a*) direct selling expenses such as sales commissions, advertising costs, title policy, and other expenses; (*b*) costs of completion or improvement; and (*c*) direct holding costs (net of rental or other income) including taxes, maintenance, and insurance during the period to be held. Some credit unions currently include the cost of all capital (debt and equity) in their calculations, which is acceptable but is not required. The FASB is currently addressing the issue of consideration of cost of capital in net realizable value calculations. Readers should be alert for the issuance of final accounting standards issued by the FASB in this area.

[23] *Fair value* is defined by FASB Statement No. 15 as the amount that a seller could reasonably expect to receive 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 but exists for similar assets, the selling prices in that market may be helpful in estimating the fair value of the assets. If no market price is available, a forecast of expected cash flows may aid in estimating the fair value of assets, provided the expected cash flows are discounted at a rate commensurate with the risk involved.

- The debtor has done either of the following:
  - Formally or effectively abandoned control of the collateral to the creditor
  - Retained control of the collateral but, because of the current financial condition of the debtor, or the economic prospects for the debtor or the collateral in the foreseeable future, it is doubtful whether the debtor will be able to rebuild equity in the collateral or otherwise repay the loan in the foreseeable future

6.10 Collateral on loans that is treated as repossessed in substance is classified as other real estate owned in the statement of financial condition. Such collateral is accounted for at its fair value, which becomes its new historical cost basis for accounting purposes. Subsequently, the collateral should be accounted for as other real estate owned, that is, at the lower of cost (fair value at the date of in-substance repossession) or net realizable value (see chapter 10 for additional guidance).

6.11 A change from a method of calculating the allowance for loan losses that is not generally accepted (for example, a calculation used for regulatory purposes) to a method that is generally accepted and that results in an adjustment to the amount previously reported is considered a correction of an error and should be reported as a prior-period adjustment. Such a change frequently arises when a credit union that has in the past undergone supervisory committee audits initially undergoes an audit in accordance with GAAS.

Financial Statement Presentation

6.12 The allowance for loan losses may be presented as a separate line item netted against loans in the statement of financial condition or in the notes to the financial statements.

6.13 For each period in which an income statement is presented, the notes to the financial statements should include a summary of activity in the allowance for loan losses account. The note should present the balance in the allowance at the beginning and end of each period, additions charged to operations, losses charged against the allowance, and recoveries of amounts previously charged off.

AUDIT OBJECTIVES AND PROCEDURES

Audit Objectives

6.14 When auditing the allowance for loan losses, the auditor is concerned primarily with the valuation assertion embodied in the financial statements. The auditor's objective when evaluating the allowance for loan losses is to obtain sufficient competent evidential matter to provide reasonable assurance that the allowance is reasonable (that is, the allowance is adequate to cover the estimated amount of loss in the loan portfolio at the date of the statement of financial condition), and that the allowance is presented in accordance with generally accepted accounting principles and properly disclosed.

Planning Considerations

6.15 The loan portfolio is usually the most significant component of a credit union's assets, and the allowance for loan losses is based on subjective judgments. The process of auditing the allowance for loan losses involves several subjective aspects, and therefore, experienced audit personnel, with relevant auditing experience, should supervise or perform this section of the audit.

The assigned audit staff should also understand the lending environment, including credit strategy, credit risk, and the lending policies, procedures, and control environment of the credit union, and should be familiar with other relevant factors such as related parties and related-party transactions, economic conditions, and government regulations. SAS No. 57, *Auditing Accounting Estimates*, provides guidance to auditors on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates in an audit of financial statements in accordance with GAAS. Additionally, the AICPA Auditing Procedure Study *Auditing the Allowance for Credit Losses of Banks* provides guidance to auditors in developing an effective approach to auditing the allowance for loan losses.

Internal Control Structure

6.16 A credit union's internal control structure may reduce the likelihood of material misstatements of accounting estimates. Specific relevant aspects of that structure include—

a. Management communication of the need for a proper allowance for loan losses.

b. Accumulation of relevant, sufficient, and reliable data on which to base the allowance.

c. Determination of the allowance by qualified personnel.

d. Adequate review and approval of the allowance by appropriate levels of authority, including—

    - Review of the sources of relevant factors on which the allowance is based.
    - Review of the development of assumptions.
    - Review of the reasonableness of assumptions and resulting estimates.
    - Consideration of the need to use work specialists.
    - Consideration of changes in previously established methods to arrive at the allowance.

e. Comparison of prior estimates of the allowance with subsequent results to assess the reliability of the process used to develop the allowance.

The following discussion highlights some of the characteristics of and considerations involved in lending by credit unions that the auditor should consider in obtaining a sufficient understanding of the internal control structure in the lending area.

6.17 <u>Credit Strategy</u>. A credit union's credit strategy includes its defined goals and objectives for loans, as well as the written loan policies to implement those goals and objectives. A guiding principle in credit strategy is to achieve profitable returns while managing risk within the loan portfolio. Credit strategy and policy should be determined by the board of directors.

6.18 The objectives of a sound credit strategy are generally to set goals for portfolio growth or contraction, and establish limits on specific loan concentrations. Also, a sound credit strategy normally incorporates credit underwriting standards as well as procedures and controls to monitor loan performance through periodic reporting and review, and to identify and monitor problem loan situations.

6.19 <u>Credit Risk</u>. An overriding factor in the credit-granting process is the amount of credit risk associated with a credit union's loans. The degree of credit risk should be addressed early in the auditor's process of obtaining an understanding of the credit union's business and its control

environment. The auditor should assess the credit risk associated with the lending process. For individual loans, credit risk pertains to the borrower's ability and willingness to pay; however, the auditor should also consider additional risks inherent in the lending process, including—

- *Collateral.* Loans collateralized by real estate, both single-family residential property and commercial property, may be a significant component of a credit union's loan portfolio. Accordingly, collateral is a major factor when assessing credit risk in a loan portfolio. A credit union may be exposed to losses on collateralized loans if its security interest is not perfected or the collateral is not otherwise under its control, or if the value of the collateral declines such that it is insufficient to cover the loan balance in the event of default by the borrower.

- *Concentration.* Credit unions are unique financial institutions. Membership may be limited to employees of one organization or to individuals of a geographic region. The makeup of the membership of a credit union should be considered when evaluating loan losses. The less diverse the membership (for example, employees of one company), the greater the risk of loss to the credit union if the sponsoring organization is experiencing financial problems or is anticipating layoffs of employees. If a region were to experience economic problems, the credit union would likely be exposed to significant losses. These factors may not always affect the outcome of the auditor's conclusions, but should be considered in the evaluation process. The required disclosures related to concentration are discussed in chapter 5.

- *Management.* Management's competence, judgment, and integrity in originating, disbursing, supervising, collecting, and reviewing loans can have a significant effect on the collectibility of loans.

- *Operations.* Funds might be disbursed without proper loan authorization, collateral documentation, or loan documentation. Failure to evaluate and monitor potentially uncollectible loans also constitutes risk.

- *Fraud or Insider Abuse.* A credit union may have increased exposure to losses if loans are not either bona fide or granted in an arm's-length transaction. SAS No. 53 provides that the auditor has a responsibility to assess the risk that irregularities may cause a material misstatement of the financial statements. Also, guidance on the auditor's responsibility when a possible illegal act is detected is provided by SAS No. 54.

6.20 Lending Policies, Procedures, and Control Environment. Definitive lending policies, comprehensive procedures for implementing the policies, and sound controls over the lending function and management reporting system are essential for maintaining the quality and safety of the loan portfolio and for ensuring the reliability of financial records. The auditor should have an understanding of a credit union's lending environment before designing specific auditing procedures. The lending process can be broadly divided into the following categories: (*a*) loan origination and disbursement, (*b*) credit monitoring, (*c*) collection, and (*d*) internal loan review.

6.21 Loan Origination and Disbursement. Loan origination involves all the processes from the original loan request to the disbursement of funds to the borrower. Specific loan-origination control features usually include—

a. Credit initiation—that is, obtaining complete and informative loan applications, including financial statements and the intended use of the proceeds.

b. Credit investigation, including—

   - Credit reports or other independent investigations.
   - Analysis of member credit information, including determination of projected sources of loan servicing and repayment.

c. Loan approval (for new and renewed loans), including—

   - Loan-approval limits according to officer expertise, administrative authority, or both.
   - Committee approval, board of directors' approval, or both for loans exceeding prescribed limits.
   - Segregation of duties between the loan approval function and the disbursement and collection functions.
   - Verification of collateral ownership and control, including lien searches and documentation of the priority of security interests.
   - Determination of collateral margin—that is, loan-to-value ratios.

d. Documentation of credit, or the inspection of supporting documents for proper form, completeness, and accuracy by someone other than the lending officer.

e. Perfection of collateral interest, or proper security filings and recording of liens.

f. Disbursements of loan proceeds, or, to the extent possible, control of disbursements to ensure that proceeds are used for the borrower's stated loan purpose.

6.22 *Credit Monitoring*. The nature and extent of credit-monitoring procedures generally vary by loan type and amount. On business loans, for instance, credit unions normally monitor credit quality by analyzing a borrower's periodic financial statements, reassessing collateral values, making periodic visits to the borrower's place of operation, reviewing industry trends and developments, and evaluating the borrower's debt-service requirements and ability to perform. On the other hand, monitoring single-family residential mortgage loans or consumer installment loans is generally less extensive unless the loans are delinquent. Management reports concerning loan activity, renewals, and delinquencies are vital to the timely identification of problem loans. Further, such information is critical to a credit union as part of its system for establishing the allowance for loan losses. A credit union's procedures and controls are important for identifying when loans should be placed on nonaccrual status, reserved for, or charged off. Most credit unions have written policies covering nonaccrual status, the timing of chargeoffs, and so on. For example, a typical policy requires nonaccrual status when reasonable doubt exists about the full, timely collection of interest or principal, or when interest or principal payments are past due ninety days or more.

6.23 *Collection*. Loans identified as problems under a credit union's established criteria are normally monitored, restructured, or sold as appropriate. A credit union normally attempts to work with the member to remedy a delinquency. Sometimes the debt is restructured to include terms the member can satisfy; at other times the credit union obtains additional collateral to support the loan. However, when the loan is delinquent for a specified period of time, normally defined in the credit union's lending policy, the credit union may begin legal proceedings, such as foreclosure or repossession, to recover any outstanding principal and interest.

6.24 If collection efforts prove unsuccessful, the loan may need to be charged off. The board of directors should authorize each chargeoff only after all collection efforts have been attempted.

The internal control structure at most credit unions typically requires periodic follow-up of previously charged-off loans, excluding bankruptcies, to determine whether collection efforts should be reinstated. Reports on recoveries of previously charged-off loans should be made to the board of directors.

6.25 _Internal Loan Review_. Periodic review by credit union personnel of the overall process and of certain individual loans, while not a substitute for continuous credit monitoring by the lending staff, is essential in assessing the quality of the loan portfolio and the lending process. The absence of an internal loan review may constitute a reportable condition, as defined in SAS No. 60, or a material weakness, as defined in SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 320.68). In addition, the lack of an internal loan review and classification system may be considered to be an unsafe and unsound practice by regulators. Internal loan review preferably should be conducted by credit union personnel who are independent of the credit origination, disbursement, supervision, and collection functions. Internal loan review may be performed by specifically assigned staff, or may be incorporated within an internal audit function. As is the case in the credit-monitoring process, the nature and extent of internal loan review procedures generally vary by loan type and may include, for example, periodic review of certain types of business loans, while limiting review of single-family residential mortgage loans to delinquencies and a sample of current-year originations.

6.26 Internal loan review may also identify weaknesses in the lending process or in the lending officers' skills in originating, supervising, and collecting loans. Internal loan review results should be documented. Some credit unions assign subjective ratings to individual loans that are similar to regulatory examination classifications. This information may be used to specifically identify potential losses in the calculation of the allowance for loan losses.

Tests of Controls

6.27 If the auditor intends to assess control risk at below the maximum in the allowance for loan losses area, the auditor should perform tests of controls directed to assessing the operating effectiveness of lending procedures, including the extent and quality of internal loan review and internal loan classifications. The auditor should also test the accuracy and perform a review of delinquency reports to determine whether the credit union initiates appropriate follow-up procedures on delinquent loans.

6.28 Effective internal loan review and internal audit departments can provide valuable assistance to the auditor and permit the auditor to increase audit efficiency. Discussions with internal loan review and internal audit staff can provide the auditor with information concerning loan members, related-party transactions, and account histories that may not be readily available elsewhere. Also, because the internal audit department is sometimes directly involved in implementing accounting systems and control procedures, it can provide the auditor with important systems descriptions of these elements of the internal control structure.

6.29 Sometimes, the internal loan review and internal audit departments' testing procedures are of such quality that the auditor can assess control risk in the allowance for loan losses area as below the maximum. However, the assessment of control risk combined with the consideration of the internal auditor's work ordinarily cannot alone reduce audit risk to a level that eliminates the necessity to test assertions related to the allowance for loan losses directly by the auditor. SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, provides guidance on using the work of internal auditors and other internal personnel who perform an internal audit function.

Substantive Tests

6.30 The nature, timing, and extent of substantive tests in the allowance for loan losses area are dependent on the auditor's assessment of inherent risk and control risk. In making that assessment, the auditor should consider the following factors:

- Lending limits placed on loan officers
- Economic and environmental conditions affecting the credit union and its borrowers
- Experience, competence, and depth of the credit union's management and staff
- Lending, charge-off, collection, and recovery policies and procedures
- Financial condition of the credit union's sponsoring organization or field of membership
- Composition of the loan portfolio
- Total amount of loans and problem loans, including delinquent and nonaccrual loans, by officer
- Trends in loan volume by major categories, especially categories experiencing rapid growth, and in delinquencies, nonaccrual, and restructured loans
- Concentrations of types of loans made (for example, auto or home improvement), concentrations of loans to individuals and their related interests or industries, or other concentrations of credit risk
- Size of individual credit exposures (few large loans versus numerous small loans)
- Identified potential problem loans, including loans classified by the credit union or regulatory examiners
- Previous loss and recovery experience, including timeliness of chargeoffs
- Results of regulatory examinations
- Related-party lending
- Operating effectiveness of the internal loan review function, the internal audit function, or both

6.31 *Audit Approach to Loan Review*. The auditor's primary responsibility when reviewing the allowance for loan losses is the evaluation of its adequacy as a whole. Because the risk and other inherent characteristics of the individual loan categories vary, the nature and extent of the auditor's separate review of each category also usually varies.

6.32 The auditor should avoid absolute reliance on mechanical formulas to assess the reasonableness of the allowance for loan losses account. However, in certain circumstances, historical analyses, which use prior loss experience to project the losses in the current loan portfolio, may provide evidence regarding the reasonableness of the account. These analytical tests may use statistics relating to the allowance for loan losses as compared to related accounts, net chargeoffs, and nonperforming loans. Another analytical tool that may be useful in assessing the reasonableness of the allowance account is delinquency analysis. This method differs from historical methods in that it considers the current condition of the loan portfolio and ignores previous loan-loss experience. Peer statistics may also provide the auditor with useful information. Review and testing of a credit union's procedures for establishing the allowance for loan losses and the review of delinquency status reports may permit the auditor to evaluate the adequacy of the allowance required for certain loan categories. The auditor should test the completeness and accuracy of delinquency reports and other documentation prepared by a credit union on which

reliance is placed. As stated previously, the use of analytical methods may provide useful information for assessing the adequacy of the allowance for loan losses. However, the results of different analytical methods may be very different or very similar. A combination of analytical procedures may provide the auditor with greater assurance. The results of analytical procedures should be analyzed in light of other known circumstances concerning loans. Particular consideration should be given to changes in the lending environment of a credit union and the effectiveness of and adherence to sound credit-extension policies and procedures.

6.33 There are many instances in which analytical methods will not produce acceptable results. The auditor may find it necessary to perform a loan-by-loan review of potential problem loans in order to effectively analyze the allowance account. An evaluation of real estate loans and business loans normally requires a more detailed review than consumer loans because the amount of individual loans is generally large and the types of borrowers and the purposes of the loans may be dissimilar. Further, a relatively small number of potential losses often can significantly affect the adequacy of the allowance. The auditor typically selects certain loans to include in the detailed loan file review. The selection of these loans generally includes (*a*) a stratum of "large" loan balances above specified amounts, based on the auditor's preliminary judgment about materiality and the amount considered material to this segment of the loan portfolio; (*b*) all "problem" loans above a certain threshold, usually lower than the amount used to select "large" loans; and (*c*) loans considered "significant" for other reasons, such as loans to related parties or loans to businesses in a troubled industry. The auditor generally considers the coverage of the loan portfolio and may decide to select additional loans for review without regard to size or other specific criteria. When reviewing loans, the auditor should be concerned with the total credit exposure of the borrower, including standby letters of credit and commitments to lend, not just outstanding loan balances.

6.34 *Sources for Identifying Problem Loans*. A number of sources can indicate potential problem loans, including the regulators' recent examination reports, which generally disclose classified loans and certain statistics regarding those classifications. The regulatory examination reports are important sources of evidential matter to the auditor in determining the nature, timing, and extent of the auditor's tests. 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.

6.35 When a regulatory examination is in progress, the auditor should normally discuss the status and preliminary findings of the examination with the examiners. See chapter 2 for additional discussion on the auditor's responsibility for making inquiries of representatives of financial institution regulatory agencies.

6.36 Additional matters to consider concerning potential problem loans include—

- Various internally generated listings, such as "watch list" loans, past-due loans, loans on nonaccrual and restructured status, loans to insiders (including directors and officers), and overdrafts.
- Management reports of total loan amounts by borrower to assist in identifying significant exposures and concentrations.
- Historical loss experience by type of loan.
- Loan files lacking current financial data related to borrowers and guarantors.
- Borrowers experiencing problems such as operating losses, marginal working capital, inadequate cash flow, or business interruptions.

- Loans secured by collateral that is not readily marketable or that is susceptible to deterioration in realizable value.
- Loans to borrowers in industries experiencing economic instability.
- Loan documentation and compliance exception reports.
- Experience and turnover of loan officers.

6.37 Additionally, indicators of troubled loans include the following:

- The underlying collateral is unable to generate enough cash flow to pay the projected legal obligation under the loan agreement.
- The terms of a debt have been modified in a troubled-debt restructuring, or a restructuring is probable.
- The creditworthiness of the borrower is in doubt because of pending or actual bankruptcy proceedings or liens filed against assets. Therefore, the loan is considered "collateral dependent" as repayment of the loan will come from operations or disposal of the collateral.
- Adverse market conditions related to sales, rentals, or other external factors cast doubt on the economic viability of the project that collateralizes the loan.
- Collateral has significantly deteriorated.
- Significant defaults, including missed payments of either principal or interest, exist under the terms of the loan agreement.
- Construction delays, cost overruns, or changes in concept or plan (for example, the conversion of a condominium project to an apartment project) are experienced on the project that collateralizes the loan.

6.38 Certain information listed above is usually found in reports prepared by the credit union independent of the general ledger and the controls over the general ledger. To the extent that such information is used by the auditor in performing substantive tests, the auditor should test its completeness and accuracy. For example, delinquent loans might be traced from the subsidiary ledgers to delinquency reports and vice versa. Tracing from the subsidiary ledger to the delinquency reports tests both completeness and accuracy; tracing from the delinquency report tests only accuracy. In this example, of course, the auditor would also need to be satisfied with the completeness and accuracy of the subsidiary ledgers. The subsidiary ledgers may already have been tested through confirmation and other detail testwork.

6.39 *Evaluating the Adequacy of the Allowance for Loan Losses*. In evaluating the amount or range of loss associated with an individual loan, the auditor reviews the expected sources of repayment and the apparent ability of the borrower to generate such repayment. In instances in which the repayment depends on the liquidation of collateral, the auditor, in reviewing the value of the collateral, considers whether the collateral will be liquidated in the normal course of business or in a manner that will cause a lesser value to be realized.

6.40 If a loan is secured by collateral, a careful evaluation and valuation of that collateral is necessary. The auditor typically evaluates the security interest in the collateral to determine if it has been perfected by execution and recording of the appropriate legal documents. The auditor also reviews the reasonableness of the credit union's collateral valuation by referring to quoted market prices or other pertinent factors, such as appraisals and engineering reports. The auditor may also test to determine the existence of collateral by physical observation, independent

confirmation, or other appropriate procedures. The allowance for loan losses on real estate loans is frequently based on information obtained from real estate appraisals. If reliance is placed on these appraisals, then the auditor should refer to the requirements of SAS No. 11, *Using the Work of a Specialist*.

6.41 When the repayment of a loan is based primarily on the borrower's ability to generate funds from profitable operations, the auditor reviews the credit union's analysis of the borrower's financial resources, liquidity and future cash flows, and other financial forecasts. These financial data may be measured against the trends and norms, both historical and forecasted for both the borrower being reviewed and the industry in which the borrower operates. It is preferable that this type of loan be supported by current audited financial statements, although financial statements that have been reviewed or compiled by the borrower's accountant or prepared internally by the borrower may be acceptable.

6.42 For loans supported by personal guarantees, the auditor may perform a review of the borrower's ability to pay. However, if it is obvious that expectation for repayment is based primarily on the creditworthiness of the guarantor, the financial statements and other information of the guarantor also are reviewed as if the guarantor were the borrower. It is also important to consider the extent of, as well as the credit union's policies and practices for, the pursuit of guarantees. The substance of a guarantee depends on (*a*) the ability and willingness of the guarantor to perform under the guarantee, (*b*) the practicality of enforcing the guarantee in the applicable jurisdiction, (*c*) the scope of the guarantee, and (*d*) a demonstrated intent to enforce a guarantee. Even if the guarantee is legally enforceable, business reasons that might preclude a credit union from enforcing the guarantee should be assessed.

6.43 Credit cards and the available credit on those cards are becoming a significant portion of many credit unions' portfolios. The auditor should consider the policies of a credit union in evaluating the application of card users, the issuance of the cards, and the collection process. Anticipated losses on the outstanding balances should be considered in evaluating the allowance account.

6.44 In evaluating loans, the auditor should avoid the following:

- *Overreliance on collateral*, or the failure to see beyond collateral values to a financial weakness in the borrower. Collateral values and liquidity often tend to decline in periods when they are most needed to protect against loan losses.
- *Inadequate collateral appraisals*, or the failure to critically review appraisals to understand the methods employed, assumptions made, and limitations inherent in the appraisal process, including undue reliance on internal appraisals. Appraisal methods and assumptions may be inappropriate for the current circumstances. The auditor should refer to the AICPA *Guide for the Use of Real Estate Appraisal Information*, which addresses the auditor's understanding of the real estate appraisal process and the auditor's use of real estate appraisal information.
- *Outdated or unreliable financial information*. Financial information should be current and complete, particularly for borrowers who are sensitive to cyclical fluctuations or who demonstrate significant growth or changes in operating philosophy and markets.
- *Excessive renewals or unrealistic terms*, or reliance on "current" or "performing as agreed" status. Excessive renewals, unrealistic terms, and interest capitalization may be indications of a transaction that has been structured to obscure weaknesses.
- *Overlooking self-dealing* of directors who improperly use their position to obtain excessive extensions of credit.

- *Dependence on management representations*, or undue reliance on management representations when there is no supporting evidence.

6.45 A credit union's management is responsible for summarizing and documenting its evaluation of the loan portfolio's collectibility. The auditor should review management's documentation and consider whether management has incorporated such factors as changes in the nature and volume of the portfolio; overall portfolio quality; loan concentration; trends in the level of delinquent and classified loans; specific problem loans, leases, and commitments; and current and anticipated economic conditions that may affect the borrower's ability to pay. It is important to consider current relevant data in calculating the allowance rather than considering the loan-loss exposure only from a historical viewpoint.

6.46 There are various methods by which management can estimate its allowance for loan losses; no single method is preferable. The auditor should consider whether the method used is consistent, comprehensive, logical, and relevant to the credit union's particular circumstances, and whether the calculation is comprehensive, taking into account the risks inherent in the various types of lending.

6.47 Although the entire allowance for loan losses is available for losses, the allowance typically consists of the following components:

- A specific portion for specifically identified doubtful or troubled loans based on estimated net realizable value of the underlying collateral. If the loan meets the criteria for in-substance foreclosure in Practice Bulletin No. 7, the amount should be written down to fair value and classified as other real estate owned (see chapter 10).
- A specific portion for pools of loans (for example, consumer loans and credit card loans).
- A specific portion for pools of classified loans.
- A general portion for all other loans.

6.48 Normally, a range of loss or an estimated loss percentage is associated with each component or with each segment within a component, other than the component of specifically identified loans. The percentage is then applied to the components or segments to determine the estimate of loss for each. Tests should be performed to provide reasonable assurance that loans are not included in more than one component or segment or improperly excluded from a component or segment. The estimated losses associated with the individual components are then accumulated to obtain the total allowance for loan losses.

6.49 The amounts provided for individual loans and pools of loans should be supplemented by a general portion for inherent losses. That amount should be based on judgments regarding risk of misstatement in the specific allowance for individual loans and pools of loans, exposures existing in the loan portfolio, and other relevant factors. Accordingly, the allowance for loan losses should be adequate to cover specifically identified loans, as well as loans and pools of loans for which losses are probable but not identifiable on a specific loan-by-loan basis.

6.50 The auditor should consider whether management's calculation of the allowance for loan losses is within a range acceptable to the auditor given the auditor's preliminary judgment about materiality levels and the amount considered material to the allowance. If the calculation is outside the acceptable range, the auditor should request that management provide additional information that the auditor can use to reassess the evaluation. If management's calculation is still outside the acceptable range, the auditor should advise that management make an appropriate adjustment. If management fails to make an appropriate adjustment, the auditor should qualify

the opinion or express an adverse opinion, depending on the materiality of the difference between management's calculation and the closest end of the range the auditor believes is best supported by the audit evidence.

6.51 In Consensus No. 85-44, *Differences between Loan Loss Allowances for GAAP and RAP*, the FASB's EITF reached a consensus that different loan-loss allowance amounts could be recorded under regulatory accounting principles (RAP) and GAAP, as the amounts computed by preparers of financial statements and regulators may differ due to the subjectivity involved in estimating the amount of loss or the use of arbitrary factors by regulators. However, the auditor should be particularly skeptical in the case of GAAP/RAP differences and must justify them based on the particular facts and circumstances.

6.52 Many credit unions attempt to justify a lower allowance for loan losses account based on the maintenance of the regular reserve. Regulators have historically stated that the regular reserve has been established to cover loan losses. While this may be true in a technical sense, the regular reserve constitutes an appropriation of undivided earnings and is not a substitute for an adequate allowance for loan losses account.

6.53 Some credit unions record a provision for loan losses equal to what would normally be transferred to the regular reserve from undivided earnings. Since the regular reserve may be reduced by the amount equal to the provision made, no regular reserve transfer is effectively made. The consequences of these actions may result in an overstatement of the allowance account. A credit union's allowance may be materially overstated due to strict adherence to this process.

Regulatory Compliance

6.54 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.

6.55 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 a 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*. A 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 that will be sustained in collection, as well as of 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

MORTGAGE-BANKING ACTIVITIES

INTRODUCTION

7.1 Growing numbers of credit unions are engaging in mortgage-banking activities. These activities consist primarily of the origination or acquisition of loans for resale to secondary market investors and the subsequent servicing of those loans. Loans can be grouped together and sold outright or pooled and securitized with or without the guarantee of a federally sponsored agency. Securitization and guarantee by agencies such as the Federal Home Loan Mortgage Corporation (FHLMC), the Government National Mortgage Association (GNMA), the Department of Veterans' Affairs (DVA), and the Federal National Mortgage Association (FNMA) significantly enhance the marketability of loans. These agencies act as both guarantors and investors. With the development of securitized mortgage loan instruments such as mortgage-backed securities, collateralized mortgage obligations, and other mortgage securities, federal agencies shifted their emphasis from merely holding loans to developing and supporting mortgage instruments that are highly liquid and attract a broader interest group within the secondary market.

7.2 Access to the secondary mortgage market can be an important source of liquidity to credit unions. Selling loans in the secondary market can affect a credit union's ability to meet its liquidity needs by generating funds for additional loans and income from servicing fees. To remain competitive, credit unions have maintained increasingly rate-sensitive deposit bases. A variable-rate funding structure cannot finance long-term, fixed-rate assets without incurring significant loss exposure in rising interest-rate environments. The ability to generate mortgage loans for resale provides an alternative source of funds. In addition, access to the secondary market also provides credit unions with opportunities to restructure their existing longer term portfolios.

7.3 When loans are originated for resale, the origination process includes not only finding an investor for a borrower, but also preparing the loan documents to fit the investor's requirements. When loans are originated for resale to government agencies as well as other private investors, compliance with specific standards governing documentation, appraisal, mortgage insurance, loan terms, and borrower qualifications is normally required. Investors will typically perform a review of the underlying documentation prior to consummation of the sale. Individual loans that fail to meet specified criteria are eliminated from the pool of loans eligible for sale. If exceptions cannot be corrected, alternative investors may be found or the loan may be transferred to the credit union's long-term portfolio. In some cases, underwriting exceptions identified subsequent to the sale of loans may subject the originating credit union to additional recourse risk if the borrower defaults on the loan.

7.4 The extent to which loans are originated for resale will differ for each credit union. Factors such as liquidity, interest-rate exposure, management policy, and capital considerations will influence the nature and extent of mortgage-banking activities within a credit union. One credit union may be managing its interest-rate risk position by intentionally selling all fixed-rate loans it originates, whereas another credit union may originate a variety of both fixed- and variable-rate loan products for resale.

7.5 When an interest in loans is sold, the selling credit union often retains the servicing of the loans. When whole loans are sold, the selling credit union may or may not retain the servicing. Servicing arrangements generally provide for the servicing credit union to maintain all records

related to the servicing agreement, to assume responsibility for billing and collecting periodic payments, and to perform all other activities necessary to the loan-servicing function.

7.6 Serviced loans may be originated by the servicing credit union itself or by other financial institutions. The credit union receives as compensation a servicing fee, normally expressed as a percentage of the principal balance of the outstanding loans, that is realized over the life of the loans as payments are received.

ACCOUNTING PRINCIPLES: MEASUREMENT AND DISCLOSURE

Loans Held for Sale

7.7 FASB Statement No. 65 states that mortgage loans and mortgage-backed securities held for sale shall be reported at the lower of cost or market value, determined as of the statement-of-financial-condition date, and that either the aggregate or individual loan basis may be used in determining the lower of cost or market value for each type of loan. The valuation of loans held for sale should incorporate the following considerations:

- Committed loans should be valued based on actual commitment prices. The contractual service fee should be valued in accordance with FASB Statement No. 65. Use of the value of loan-servicing rights to offset or eliminate unrealized valuation losses should be considered only if a fixed contract exists for the sale of servicing on identifiable loans held for sale.
- The market value for uncommitted loans should be based on the market in which the credit union normally operates (for example, servicing retained or released).
- Changes in the valuation allowance should be included in the determination of net income.
- Loans that are to be transferred from loans held for resale to long-term investments should be valued at the lower of cost or market at the transfer date.

Sales of Loans

7.8 In accounting for sales of loans, the objectives are to recognize in the period of sale the economic gain or loss from the transaction and to avoid including in the period of sale income or expense attributable to future periods. Consequently, when loans are sold outright and are not to be serviced by the selling credit union, the gain or loss is measured by calculating the difference between the selling price and the carrying amount of the loans sold (less applicable deferred loan fees, if any). Generally, variable-rate loans are sold at stated rates, with gain or loss measurement based on a premium or discount on the face value of the portfolio to be sold, and fixed-rate loans are sold at a discount or premium to provide a specified yield to the investor. The corresponding gain or loss is based on the difference between the actual or stated yield of the loans to be sold and the contractual yield to the investor. The stated yield on a pool of loans is the calculated weighted average interest rate for that pool. Consistent with FASB EITF Consensus No. 88-11, gain or loss is then determined by capitalizing the present value of the interest spread inherent in the stream of payments over the estimated life of the loans. The rate used to discount should be similar to that which the market would demand for a similar instrument (for example, an interest-only strip). The resulting premium (that is, excess servicing asset) or discount (liability) should be deferred and amortized in such a manner as to result in a constant rate of interest when applied to the uncollected balance of the underlying loans. Accordingly, prepayments of the underlying loans directly affect the asset or liability valuation and should be evaluated continually to ensure that amortization is appropriate.

7.9 If loans are sold with servicing retained, and the servicing fee rate differs materially from a normal servicing fee rate (see FASB Statement No. 65 and FASB Technical Bulletin No. 87-3), the sales price should be adjusted, for purposes of determining gain or loss on the sale, to provide for the recognition of a normal servicing fee in each subsequent year. The amount of the adjustment is the difference between the actual sales price and the estimated sales price that would have been obtained if a normal servicing fee rate had been specified (excess servicing). FASB EITF Consensus No. 88-11 states that the difference between the normal and stated servicing fees, if any, over the estimated life of the loan should be calculated using prepayment, default, and interest-rate assumptions that market participants would use for similar financial instruments and should be discounted using an interest rate that a purchaser unrelated to the seller of such a financial instrument would demand. Therefore the discount rate should be comparable to the rate on similar financial instruments, and should reflect the risks associated with the asset. Prepayment estimates should be made using common marketplace assumptions used in estimating prepayments for similar instruments. For loans accounted for at amortized cost, the carrying amount is generally the outstanding principal balance less such adjustments as purchase premium or discount and net deferred loan fees or costs. Once a decision has been made to sell loans, they should be carried at the lower of cost or market; gains, however, should not be recognized before the closing of the sale, that is when title and all risks and rewards have been irrevocably passed to the buyer, and there are no significant unresolved contingencies.

7.10 FASB Statement No. 65 established authoritative standards for accounting for loan sale transactions. FASB Technical Bulletin No. 87-3 provides additional guidance on accounting for mortgage servicing fees and rights. The FASB's EITF has also issued guidance on a variety of mortgage-banking issues including sales of participations and implications of prepayments for the valuation of deferred loan sale premiums. Because of the complexity and variety of issues associated with loan sale transactions, FASB pronouncements should be consulted when a credit union's financial statements include loan sale transactions.

Sales of Loans With Recourse

7.11 Credit unions may sell loans on a with-recourse basis to a government agency or private investors. This may be done to deliver loans into a particular investor's commitment program, to obtain a better price, or both. Because of the increased risk of delinquency and foreclosure, a credit union's management should evaluate its contingent liability with respect to such loans. Chapter 5 and FASB Statement No. 77 provide guidance for sales of loans with recourse.

Servicing

7.12 In addition to the fee income they generate, servicing rights have intrinsic value because of the servicer's ability to invest the "float" that results from payments that are received from borrowers but are not yet passed on to the owners of the loans. Additionally, intrinsic value components of servicing rights include ancillary income, such as late-payment charges and prepayment charges. Accordingly, servicing rights, either separately or as part of a loan, are generally readily purchased and sold. If loans have been sold previously with servicing retained, a subsequent sale of servicing rights generally will result in income recognition, subject to conventional revenue-recognition rules and regulatory approval of the transfer of servicing. Conversely, purchased servicing rights may be capitalized and amortized against future service fee income. If servicing is sold and the related loans are retained, immediate income recognition is inappropriate; the proceeds should be accounted for in a manner similar to a loan discount and accreted into income using the interest method. Gains and losses on the sale of servicing rights when the loans are retained are recognized as adjustments to the yield of the related loans.

Purchased Servicing Rights

7.13 When servicing rights are purchased, the amount capitalized represents the buyer's estimate of the present value of the future net servicing fee revenue stream. The valuation process involves making assumptions about the expected life of the loans and related outstanding average principal balances, anticipated delinquencies and foreclosure losses, estimated escrow balances, and other factors. Because it is not always possible to achieve these assumptions, it is extremely important that the recoverability of purchased servicing rights be evaluated periodically.

7.14 FASB Statement No. 65 and FASB Technical Bulletin No. 87-3 provide guidance on the accounting treatment of purchased servicing assets recorded upon acquisition of a loan. FASB EITF Consensus Nos. 85-13, *Sale of Mortgage Service Rights on Mortgages Owned by Others*, 86-38, *Implications of Mortgage Prepayments on Amortization of Servicing Rights*, and 86-39, *Gains from the Sale of Mortgage Loans with Servicing Rights Retained*, provide guidance on purchased servicing valuation, implications of prepayments, and the impact on the purchased servicing asset of gains on the subsequent sale of underlying loans.

Sale of Servicing Rights

7.15 The contractual right to service loans may represent a significant asset of a credit union. Internally originated servicing rights relating to the credit union's loan origination are not reflected on a credit union's statement of financial condition, but purchased servicing rights are recognized. Servicing rights, as already discussed, have significant value, and a ready market exists for them. Thus, a credit union's portfolio of servicing rights represents a potential source of earnings and capital provided that the underlying loans have already been sold.

7.16 Generally, three to six months will elapse between the contract to sell servicing and the actual delivery of the loan portfolio to be serviced. These delays may result from the purchaser's inability to accept immediate delivery, the seller's inability to immediately transfer the servicing records and loan files, delays in obtaining necessary regulatory approval, or other planning considerations. Because of the complexity of issues relative to the transfer of risks and rewards between the buyer and the seller of servicing rights, FASB EITF Consensus No. 89-5, *Sale of Mortgage Loan Servicing Rights*, indicates that a sale of mortgage servicing rights should not be recognized before the closing date, that is, when title and all risks and rewards of ownership have irrevocably transferred to the buyer and there are no significant unresolved contingencies.

7.17 If a closing has taken place in which the seller has received cash or an adequate cash down payment and acceptable notes or other consideration, and the contractual title and the risks and rewards of ownership have passed, the possible criteria by which the auditor would determine whether any significant unresolved contingencies exist include the following:

- The seller must receive written approval from the applicable regulatory agency. The buyer must be a currently approved seller/servicer, and the buyer cannot be at risk of losing approved status.
- The likelihood of the rejection or return of servicing by the buyer pursuant to the representation and warranties clauses of the sale contract is remote. Accordingly, the pool must be eligible for transfer, and the seller's underwriting/documentation review and servicing procedures must be adequate to ensure transfer. Also, due diligence procedures must have been completed by the buyer and, desirably, the initial approval of transfer must have been received by the appropriate approving agency. Finally, the buyer should be able

to return the servicing right only because it does not meet agreed-upon standards and not because the loan defaulted or was prepaid subsequent to closing.

- In the event of a sale in which the seller finances a portion of the sales price, an adequate nonrefundable down payment is necessary to demonstrate the buyer's commitment to pay the remaining sales price (at least 20 percent), and the note receivable from the buyer must provide full recourse to the buyer. Nonrecourse notes or notes with limited recourse (such as to the servicing) would not be acceptable. The note should provide for a market rate of interest.
- Temporary servicing performed by the seller for a short period of time should be compensated for in accordance with a subservicing agreement that provides a normal servicing fee. Any benefits related to escrow deposits held by the seller during the temporary servicing period should accrue to the buyer.

7.18 Servicing rights may be purchased by a broker or investment banker who intends to seek a buyer for the rights. Although such a purchase is noncancelable, approval of transfer of the rights is not requested by the seller until the broker enters into a transaction with the third-party purchaser. This should generally be characterized as a financing transaction. A sale has not occurred until approval of transfer of rights has been requested, even though other contingencies are resolved. FASB EITF Consensus Nos. 87-34, *Sale of Mortgage Servicing Rights with a Subservicing Agreement*, 89-5, *Sale of Mortgage Loan Servicing Rights*, and 90-21, *Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement*, provide additional guidance.

DVA No-Bids and Private Mortgage Agencies

7.19 Historically, the DVA would pay a lender 100 percent of the outstanding debt on a defaulted loan. In return, the lender would turn the borrower's house over to the DVA, which would dispose of it. The DVA currently has the option of guaranteeing the lesser of 60 percent of a loan's original balance or $27,500, leaving the property with the lender if that were less costly for the agency. Called a "no bid" option, this practice was seldom used, especially since inflation pushed up housing prices during the late 1970s and early 1980s. However, as inflation began to slow and the costs of carrying a foreclosed house began to rise, the DVA began to invoke the no-bid option. The amount of no-bid activity has increased sharply in the last few years. Particularly hard hit have been mortgage lenders in economically depressed areas, such as energy-producing and agricultural regions of the United States. Additionally, credit unions may incur losses due to the uncollectibility of receivables from other government programs such as the FHA, the GNMA, or the FHLMC, or from insolvent private mortgage insurers.

7.20 With the increased risk of foreclosure losses, including unrecoverable interest advances; foreclosure costs such as attorneys' fees, inspections, and so forth; and the implicit cost to carry the asset until ultimate sale, the evaluation of loss allowances on DVA and privately insured mortgage loans has become increasingly difficult. Credit unions involved in mortgage-banking activities should write down properties to fair value at the time of actual or in-substance foreclosure. Accordingly, each property should be evaluated based on current appraised value less costs to sell, such as commissions, closing costs, anticipated repairs, and sales and financing incentives. After foreclosure, a periodic review should be made of market conditions, past experience, and disposition objectives to ensure that such properties are carried at amounts not exceeding net realizable value. Chapter 10 provides guidance on the evaluation of foreclosed real estate, and chapter 6 provides guidance on the evaluation of the collectibility of real estate loans.

Financial Statement Presentation

7.21 Loans held for sale should be presented separately on the face of the statement of financial condition and should be reported at the lower of cost or market value. The amount of aggregate gains or losses on sales of loans should be presented on the face of the statement of income. FASB Statement No. 65 states that the method used in determining the lower of cost or market value of mortgage loans and mortgage-backed securities (that is, aggregate or individual loan basis) shall be disclosed. The amount capitalized during the period in connection with acquiring the right to service mortgage loans, the method of amortizing the capitalized amount, and the amount of amortization for the period shall be disclosed. Disclosures should also include—

- The amount of the servicing portfolio maintained by the credit union.
- A rollforward of deferred loan sale premium or discount activity (normal amortization, amortization due to changes in prepayment assumptions, changes due to loan sale activity, and so on) for each year of operations presented.
- The nature and extent of any recourse provisions caused by, for example, borrower default or technical underwriting exceptions associated with both the credit union's servicing portfolio and the loans that the credit union may have subsequently sold.
- The amount of aggregate gains on sales of servicing included in operations.
- A rollforward of purchased servicing activity (purchases, sales and amortization, and so forth) for each year of operations presented.
- The nature and extent of off-balance-sheet escrow accounts.

AUDIT OBJECTIVES AND PROCEDURES

Audit Objectives

7.22 Audit objectives and procedures for loan origination and underwriting are discussed in chapter 5. The primary audit objectives pertaining to other mortgage-banking activities are to determine that—

- Loans held for sale are properly classified and are stated at the lower of cost or market.
- Escrow advances are properly recorded and collectibility is reasonably assured.
- Gains and losses on the sale of loans or related servicing rights are properly measured and recorded.
- Deferred loan sale premiums or discounts are stated at recoverable amounts.
- Purchased servicing rights are stated at recoverable amounts.
- Proper title has passed to the holder of purchased servicing rights.
- Allowances for possible losses associated with servicing responsibilities, sales with recourse, or other factors are adequate.

Planning Considerations

7.23 In planning the audit, the auditor should obtain an understanding of management's business strategy with respect to mortgage-banking activities. The auditor should inquire about how the mortgage-banking activities relate to management's objectives for addressing interest-rate risk and

enhancing liquidity. In obtaining an understanding of management's strategy, the auditor should also inquire about the extent to which loan losses can be sustained to restructure existing long-term, fixed-rate portfolios, and the extent to which securitization, recourse provisions, and other negotiable loan sale terms can be negotiated to maximize price and minimize risk. The auditor should also inquire about the reporting systems used by management, and should consider whether management has sufficient data to evaluate loan sale transactions, identify loans held for sale, and track mortgage loan commitments and applications. This information is usually needed by management to contain risks arising from mortgage-banking activities.

7.24 In evaluating whether loans are held for sale or investment, the auditor should consider management policy and practices (for example, previous loan sale activity, types of loans sold, transactions subsequent to year end, and pending contracts), and whether management has the ability and intent to hold the loans for the foreseeable future or until maturity. The auditor should be satisfied that all loans held for sale within a loan portfolio are properly identified and accounted for at the lower of cost or market.

7.25 A credit union acting as a servicer of loans has a fiduciary responsibility to third-party investors. Failure to meet these responsibilities is a contingency that could have a material effect on a credit union's financial statements. When servicing mortgages for service agents such as the GNMA, the FNMA, and the Department of Housing and Urban Development (HUD), a credit union must meet certain minimum net worth requirements. Inability to meet the requirements could result in termination of the service contract. Thus, the auditor should consider whether a credit union's servicing systems ensure proper controls over investor and escrow accounts. The auditor should consider the potential for a contingent liability associated with noncompliance with investor-servicing requirements.

Internal Control Structure

7.26 The discussions of internal control structure policies and procedures in chapters 5 and 6 are also relevant to mortgage-banking activities.

7.27 *Policies and Procedures*. Examples of typical internal control structure policies and procedures relating to mortgage-banking activities include—

- Use of a quality control or internal audit function to monitor underwriting and documentation practices.
- Executive management review of open and pending commitments and strategies to minimize exposure to changing interest rates.
- Periodic reconciliation of cash receipts and payments applied to the servicing (investor and escrow) system.
- Periodic reconciliations of custodial accounts. (The frequency of reconciliation should be determined by the level of account activity.)
- Periodic reconciliation of servicing fees received to servicing fee income recorded in the general ledger.
- Periodic evaluation of the recoverability of deferred loan sale premium, purchased servicing values, and other capitalized costs.

Tests of Controls

7.28 The auditor may believe that audit efficiency can be improved by assessing control risk at below the maximum for mortgage-banking activities. Tests of controls that may be used to obtain evidence to support such an assessment include—

- Selecting a sample of borrower remittances and testing allocation of payment amounts to income, principal, escrow, and service fee accounts.
- Reviewing custodial account reconciliations and supporting documentation to ensure that all activity is processed and cleared currently.
- Recalculating a sample of loan sale transactions to ensure proper calculation of weighted average rates and corresponding gains or losses.
- Selecting a sample of delinquent loans serviced and considering whether collection and follow-up procedures are performed on a timely basis and are in accordance with investor requirements.
- Examining loan documentation (see chapter 5).

Substantive Tests

7.29 The scope of audit procedures for mortgage-banking activities is affected by regulatory matters and the need to provide special-purpose reports to investors. However, the following substantive tests relating to mortgage-banking activities may also be appropriate:

- Reviewing and testing the documentation supporting custodial/escrow and investor account reconciliations. Custodial accounts may be off-balance-sheet accounts. Accordingly, the auditor may need to select custodial accounts from records independent of the general ledger. In this case, the auditor may need to perform separate tests of the completeness and accuracy of custodial records.
- Evaluating the propriety of loan classifications to determine that all loans held for sale within the loan portfolio are properly identified.
- Reviewing the documentation and recalculating the amounts supporting the measurement of lower-of-cost-or-market valuation for loans held for sale.
- Confirming a sample of individual loan accounts serviced for investors. The confirmation should include escrow balances, interest and principal due, and other pertinent loan terms.
- Selecting a sample of loan sales made during the period and reviewing investor contracts to evaluate whether excess and normal servicing fees, weighted average interest-rate calculations, sale versus financing treatment, and so on have been treated properly.
- Analytically projecting service fees for comparison with service fees reported in operating income for the period.
- Analyzing prepayment data used by management to calculate deferred loan sale premiums at sale date and the systems used to update prepayment data over time for actual prepayment experience, selecting a sample of loan pools sold in prior periods, and comparing the actual current loan balance with estimates.
- Evaluating the adequacy of allowances for servicing and escrow advances. Some investors require that contractual interest and principal be remitted to them by the servicer regardless of member performance. Advances of such amounts are frequently made in anticipation

of borrower performance and must be tracked on an individual basis to limit exposure to uncollectible advances.

- For purchased servicing rights and excess servicing fees, reviewing the assumptions used in the valuation process, considering their current reasonableness, and evaluating the effect of changes in assumption or recoverability.
- Evaluating the adequacy of the allowance for loan losses because of recourse provisions and the DVA no-bid options. Loan sale/servicing agreements generally address recourse provisions and should be reviewed for all substantial investors to ensure that portfolios sold with recourse are included in reserve adequacy considerations. Chapter 6 provides further guidance on loan-allowance testing.

Chapter 8

MEMBERS' SHARE AND SAVINGS ACCOUNTS

INTRODUCTION

8.1 The principal source of funds used in the operation of a credit union is the members' share and savings deposits. The members of a credit union are also its owners. The savings of the owner-members are frequently referred to as *share accounts*; the interest paid on the accounts is often called a *dividend*. Historically, the regular share account was the primary form of members' savings accounts. Other types of deposits, including share drafts (or checking accounts), money market accounts, share certificates of deposit, and individual retirement accounts (IRAs), have become an increasingly larger portion of the total savings deposits at credit unions.

8.2 The major types of interest bearing savings accounts are demand and time deposits and include the following:

- *Demand Deposits*
  - *Regular shares* are normal savings accounts that do not require a member to maintain a balance of greater than a minimum balance and do not normally require notice of intent to withdraw.
  - *Share draft accounts* (or checking accounts) are savings accounts from which withdrawals can be made from remote locations through the use of drafts (checks).

  Access to funds in both of the preceding types of accounts can be accomplished through automated-teller-machine (ATM) transactions and preauthorized payment transactions. Deposits can be made through direct deposit of payroll checks, over-the-counter deposits, and ATM transactions.

  - *Money market accounts* represent deposit accounts that may require a minimum balance and offer a higher rate of interest, but they may have limits on the number of transfers or withdrawals permitted.
- *Time Deposits*
  - *Share certificate of deposit accounts* are deposits evidenced by a certificate that must be held for a minimum amount of time and may contain a provision for assessment of an interest penalty for early withdrawal.
  - *IRAs* are accounts designed to provide tax benefits for certain contributions to and interest earned on the account.

8.3 Certain credit unions may also permit nonmembers to deposit funds in their institution, subject to certain restrictions.

8.4 Within the above categories, certain accounts may become inactive or dormant with the passage of time. These accounts are classified as dormant at the discretion of the individual credit union. After a specific period of inactivity, as determined by the state in which the credit union is located, the deposits must be escheated to the state, rather than remain on deposit with the credit union.

ACCOUNTING PRINCIPLES: MEASUREMENT AND DISCLOSURE

8.5 The disclosures that credit unions should make related to members' share and savings accounts are—

- Major types of interest-bearing and non-interest-bearing deposits by interest-rate ranges.
- The weighted average interest rates at which the credit union paid interest on deposit accounts and the related deposit balances at year end. Typically, this is broken out by type of deposit.
- Contractual maturities of time deposits specifying balances maturing for each of the five years following the date of the most recent statement of financial condition being presented and thereafter.
- Securities or mortgage loans pledged as collateral for certain deposits.
- Income from early withdrawal penalties, if material.
- Demand accounts that are overdrawn, which should be included with loans. The overdrafts should be evaluated for collectibility as part of the allowance for loan losses. If material, deposits received from related parties should be disclosed.
- Accounts over $100,000.
- The means by which interest rates are determined by the board of directors.

Credit union management should also consider disclosing interest expense by type of account.

Financial Statement Presentation

8.6 Federal credit unions are required to report members' shares as equity for regulatory purposes. All member deposit accounts of a credit union, including member shares, are required under generally accepted accounting principles to be classified as liabilities in the statement of financial condition. It must be unequivocal on the face of the statement of financial condition that savings accounts are a liability. The statement of financial condition must either (*a*) present savings accounts as the first item in the liabilities and equity section or (*b*) include savings accounts within a captioned subtotal for total liabilities. An unclassified presentation whereby all liabilities and equity are shown together under one subheading and savings accounts are presented as the last item before retained earnings does not represent an acceptable presentation. The interest paid or accrued on these accounts, commonly referred to as *dividends*, should be reported as an expense on the statement of income, and the amount of interest payable to members should be included as a liability on the statement of financial condition. This is the same position that the FASB's EITF took in Consensus No. 89-3, *Balance Sheet Presentation of Savings Accounts in Financial Statements of Credit Unions.*

AUDIT OBJECTIVES AND PROCEDURES

Audit Objectives

8.7 The principal audit objectives related to a credit union's share and savings deposits are to determine that—

- The deposits and related expense accounts are fairly stated in conformity with generally accepted accounting principles.
- The accounts are properly presented in the financial statements.

Internal Control Structure

8.8 An effective internal control structure should include policies and procedures and an adequate segregation of duties to (*a*) ensure that deposits are accepted in accordance with established policies, (*b*) prevent and detect errors in the processing of accounting information for deposits, and (*c*) ensure that deposits are monitored on an ongoing basis and that expense recognition and the carrying amount of liabilities are analyzed periodically to determine whether adjustments are necessary.

8.9 Examples of typical internal control structure policies and procedures relating to deposits include the following:

- *Reconciliation.* The detail subsidiary ledgers are reconciled to the general ledger on a periodic basis. This includes the interest accruals as well as the deposit principal balances.
- *Authorization.* Appropriate individuals, typically officers or supervisory employees, are assigned responsibility for approving unposted holdover items, overdrafts, return items, and activity on dormant accounts.
- *Safeguard Controls.* Controls should be in place to ensure adequate protection of files, ledger cards, canceled checks, deposit tickets, and signature cards. Typically, these items are maintained in fireproof containers, and access is restricted to appropriate personnel. In addition, the supplies (typically prenumbered) of unissued certificates of deposit should be maintained under dual control.
- *Segregation of Duties.* Control procedures should provide adequate segregation of duties for deposits. Persons responsible for opening new accounts and issuing certificates should not have access to the accounting records. Accounting personnel should not have processing duties or access to unissued certificates.
- *Statements.* Statements of account activity are mailed to the depositor on a regular basis. Returned statements are properly controlled and adequate follow-up is performed.
- *Wire Transfers.* Appropriate controls should exist over wire transfers and the propriety of the subsidiary ledgers (see paragraph 3.11).
- *Employee Accounts.* An appropriate individual should be assigned to review activity in employee accounts for unusual or unauthorized transactions.

Tests of Controls

8.10 Tests of controls of the policies and procedures related to members' deposits include—

- Reviewing the control over origination of, and access to, signature cards.
- Comparing the withdrawal slips with the applicable signature cards.
- Reviewing the control over origination of, and access to, mailing address files.
- Reviewing the control over mail receipts.
- Testing accounts for compliance with the credit union's policy regarding early withdrawal penalty interest recognition.

- Reviewing dormant account control procedures and transactions relative to deceased accounts.
- Testing restrictions on savings accounts pledged as collateral for loans.

Substantive Tests

8.11 The auditing procedures employed to audit members' share and savings deposit accounts are primarily substantive in nature. The auditor may decide to perform certain of these audit procedures at an interim date. Before doing so, however, the auditor should assess the difficulty of controlling the incremental audit risk. SAS No. 45, paragraphs 5 through 7, provides guidance in making the assessment.

8.12 *Account Reconciliations*. The auditor needs assurance that the account information to be confirmed and tested actually represents the record for the data selected. Therefore, the auditor should agree the subsidiary ledger records for member deposits to the general ledger control accounts, test the ledgers for mathematical accuracy, and test the reconciliation of its subsidiary totals to the general ledger balance. Reconciling items of differences between the general ledger and the subsidiary ledger that are of particular concern are returned items, adjustment items, holdovers in departments, overdrafts, and service charges. The auditor may decide to test subsequent disposition of, or proper approvals for, reconciling items.

8.13 *Confirmation*. Confirmation of deposit account balances provides evidence of existence and accuracy. The extent, type (positive or negative), and method of selection and evaluation are left to the auditor's judgment.

8.14 It should be noted that one of the explicit duties of a federally insured credit union's supervisory committee is to perform a verification of the members' accounts. In order to comply with the rules set forth by the NCUA, this verification shall be made using any of the following methods:

- A controlled verification of 100 percent of members' share and loan accounts.
- 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 with an equal chance of being selected.

8.15 Records of those account verifications must be maintained and retained until the next verification of members' accounts is completed for regulatory purposes.

8.16 SAS No. 39 provides that either statistical or nonstatistical sampling, when properly applied, can provide sufficient evidential matter in the context of GAAS. 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 using statistical sampling should be in compliance with NCUA rules and regulations because coordination of the confirmation process for GAAS and supervisory committee audit purposes is normally encouraged by the supervisory committee.

8.17 Confirmation requests generally should be prepared as of the date selected for performing other auditing procedures for the corresponding subsidiary ledgers. If a judgmental sampling methodology is utilized, the selection should include a representative sample of active as well as dormant accounts, large and unusual accounts, and accounts closed during the audit period.

8.18 Some members may have instructed the credit union that their accounts be treated 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 post office should be subjected to alternative procedures, such as confirmation by personal contact with the member or review of account activity. If alternative procedures are not practicable, the auditor should consider whether a scope limitation exists.

8.19 <u>Tests of Interest Payable and Interest Expense</u>. Accrued interest payable, interest expense, and service charge income should be tested in connection with the audit of members' share and savings accounts. Test procedures for interest on these deposits 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 reasonableness 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 for reasonableness and to determine that the fees were charged in accordance with the credit union's policy.

Chapter 9

BORROWED FUNDS

INTRODUCTION

9.1 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.

9.2 A credit union may be involved with several different categories of borrowed funds, including—

- Notes payable (to other financial institutions, the Corporate Credit Union, the Central Liquidity Facility, or the Federal Reserve Bank).
- Promissory notes to members and nonmembers.
- Mortgages payable.
- Capitalized lease obligations.
- Federal funds payable.
- Letters of credit.
- Reverse-repurchase agreements.

Certificates of Indebtedness

9.3 Certificates of indebtedness, a special form of time deposits, 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. 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

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

Capital Lease Obligations

9.5 A capital lease obligation results from a financing transaction that is structured as a lease that transfers substantially all the benefits and risks inherent in the ownership of the property to the lessee, who accounts for the lease as an acquisition of an asset and the incurrence of a liability. FASB Statement No. 13, *Accounting for Leases*, and subsequent amendments provide guidance for identifying and accounting for capital lease obligations.

Federal Funds Purchased

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

Letters of Credit

9.7 Letters of credit are versatile instruments commonly used as a type of guarantee (usually referred to as a *standby credit*). Standby credit represents the bulk of the growth in the use of letters of credit in the past few years. Standby credits are often used in lieu of suretyship contracts and arrangements that call for some guarantee of performance or payment.

Reverse-Repurchase Agreements

9.8 Reverse-repurchase agreements (reverse repos) involve an agreement to sell and repurchase identical certificates within a specified time at a specified price (see further discussion at paragraph 4.14).

ACCOUNTING PRINCIPLES: MEASUREMENT AND DISCLOSURE

9.9 Significant categories of borrowings by type may be presented as separate line items in the liabilities section of the statement of financial condition or as a single line item with appropriate note disclosure of components. The related notes to the financial statements should describe the principal terms of the respective agreement including, but not limited to, the title or nature of the agreement or both, the interest rate, the payment terms and maturity date(s), collateral, and restrictive covenants, if any. The financial statements should also disclose, for each of the five years following the date of the latest statement of financial condition presented, the combined aggregate amount of maturities for all long-term borrowings.

9.10 Financial statement disclosures are required for all operating leases of lessees having noncancelable lease terms in excess of one year as they relate to minimum future rent payments, minimum sublease income, and a schedule of total rental expense.

9.11 Reverse repos are accounted for either as the sale and subsequent repurchase of securities or as a collateralized borrowing arrangement (financing). The key factor in distinguishing between the sale and repurchase of securities and a financing arrangement for accounting purposes is the degree of control over the future economic benefits relating to the securities sold and reacquired by the seller-borrower. If the security sold is the identical security repurchased as in a reverse repo, the seller-borrower has retained control over the future economic benefits relating to the security and has assumed no additional market risk (assuming there are no provisions in the agreement to the contrary). Thus, the transaction is generally accounted for as a financing arrangement.

9.12 For a reverse repo accounted for as a financing, a liability should be recorded at the time of sale for the amount of the proceeds. The investment account should not be relieved of the collateral securities. Interest paid to the buyer-lender during the sale and repurchase period should be accounted for as interest expense. Also, the difference between the selling price and the repurchase price should be accounted for as interest expense recognized over the term of the agreement. Interest expense recognized under these agreements should not be offset against the interest income on the security sold; they should be reported on a gross basis.

9.13 The following should be disclosed in the financial statements, or in the notes to the financial statements, with respect to reverse repo transactions and agreements:

a. Disclosures for the end of the period should include—

- A description of the securities underlying the agreements.
- The book value, including accrued interest, of the securities underlying the agreements.
- The market value of the securities underlying the agreements.
- The maturity of the agreements.
- The weighted average interest rate of the agreements.
- The dollar amount of agreements to repurchase the same securities.
- The dollar amount of agreements to repurchase substantially identical securities.
- Any material concentrations at the end of the period.[24] If any material concentrations exist at the end of the period, disclosure should be made of the credit union's control of the securities underlying the agreements.[25] If concentrations at the end of the period vary from those during the period, consideration should be given to disclosing this information.
- Financial instruments with off-balance-sheet risk. FASB Statement No. 105 requires disclosure of certain information about financial instruments with off-balance-sheet risk. Reverse repos accounted for as a sale have off-balance-sheet risk of loss due to both credit risk and market risk. See the discussion of the disclosure requirements of FASB Statement No. 105 in chapter 5.

b. Disclosures for reverse repos during the period should include the following:

- The maximum amount of outstanding agreements at any month end during the period.
- The average amount of outstanding agreements for the period.
- A statement of whether the securities underlying the agreements were under the credit union's control.

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[24] *Material concentration* refers to the dollar amount of assets at risk under agreements outstanding at the report date with any one dealer. *Assets at risk* is defined as the book value of securities sold under agreements to repurchase, including accrued interest plus any cash or other assets on deposit to secure the repurchase obligation, less the amount borrowed against it (adjusted for accrued interest). Materiality should be considered in relation to the credit union's net worth as well as to its operations.

[25] *Control* refers to the ability of the credit union to exercise legal authority over the securities that serve as the collateral for the repurchase-reverse repurchase agreement in the event of default by the counterparty. The credit union has a different loss exposure if it lacks control over the collateral in a repurchase transaction than if it lacks control over the collateral in a reverse-repurchase transaction. In a reverse agreement, the counterparty, for its benefit, usually exercises control over the securities underlying the agreement. The credit union has a risk of exposure to the extent that its assets that serve as the collateral exceed the amount borrowed, including accrued interest.

AUDIT OBJECTIVES AND PROCEDURES

Audit Objectives

9.14 The primary audit objectives for borrowings are to determine that—

- Short- and long-term borrowings recorded as of the date of the financial statements include all such liabilities of the credit union, are stated in correct amounts, and reflect all transactions for the period in accordance with generally accepted accounting principles.
- Interest expense and the related statement-of-financial-condition accounts (accrued interest payable, unamortized premiums or discounts, and issuance costs) are properly measured and recorded, and amortization has been computed in accordance with generally accepted accounting principles.
- All borrowed funds are authorized, properly classified, recorded in the proper period, and are properly described and classified in the financial statements, and related note disclosures are adequate.

Planning Considerations

9.15 In planning the audit, the auditor should consider the factors influencing inherent risk as it relates to other borrowings. Such factors might include regulatory considerations, the existence of restrictive covenants, and the existence and adequacy of collateral, if applicable. The auditor should also obtain and read the current year's interim financial statements and other financial information. This might include information about whether any significant new debt has been incurred or issued and whether any significant debt has been repaid or refinanced.

Internal Control Structure

9.16 Internal control structure policies and procedures relating to borrowings include the following:

- Borrowing transactions are reviewed and approved by the board of directors and documented in the minutes.
- Adjustments to liability accounts are reviewed and approved by a responsible official.
- The credit union is named as issuer or borrower in the respective credit or financing agreements.
- The long- and short-term borrowings subsidiary ledger is periodically reconciled with the general ledger.
- Reports and statements from outside entities are periodically reconciled with the credit union's records.

Tests of Controls

9.17 It is generally more efficient and effective to assess control risk at the maximum for other borrowings and to take an entirely substantive approach to the examination of other borrowings. The auditor should, however, obtain an understanding of relevant internal control structure policies and procedures to plan effective substantive tests.

Substantive Tests

9.18 The auditor should obtain copies of and review documentation supporting other borrowings and agree items to their recording in the subsidiary ledger to ensure that liabilities have been properly recorded. Consideration should be given to—

- The type of debt.
- The maturity of the debt.
- The underlying collateral of the debt, if any.
- The subordination of the debt to other borrowings.
- Restrictive debt covenants.

9.19 Confirmation. The auditor should confirm pertinent information with the credit grantor, including all terms, unpaid balance, accrued interest payable, principal and interest payments made during the year, and collateral description, and determine adherence to the terms of the agreement. If collateral is not under the control of the credit union and is held by a trustee, the auditor should confirm its existence, completeness, and valuation with the respective trustee.

9.20 Analytical Procedures. Analytical procedures that may be useful for other borrowings include the following:

- Compare interest expense by major category of debt as a percentage of the average amount of the respective debt outstanding during the year with stated rates on the debt instruments.
- Evaluate the reasonableness of statement-of-financial-condition accruals and other related statement-of-financial-condition accounts (accrued interest payable, deferred issuance costs, and premiums and discounts).

9.21 The auditor should consider whether changes in relationships or differences from expectations require additional investigation based on his or her judgment about materiality.

9.22 Other Procedures. Other audit procedures related to other borrowings include the following:

- Read minutes of meetings of the board of directors and test whether financing transactions, including such debt equivalents as capitalized leases, have been properly authorized.
- Obtain a detailed supporting schedule with prior-year balances and current-year balances. Agree the prior-year balance to prior-year working papers and the current-year balance to the general ledger. Review activity for reasonableness.
- Compare the cost of funds during the period with the expected cost of funds based on terms of respective agreements and previous experience; investigate any significant discrepancies.
- Review debt covenants and test whether the credit union has complied with such covenants. Determine whether disclosures are appropriate.

- Examine lease agreements; identify those that should be capitalized and determine whether they were recorded using effective rates of interest in conformity with generally accepted accounting principles.
- Confirm and verify line of credit agreements and determine whether appropriate disclosures have been made.

Chapter 10

OTHER ASSETS AND OTHER LIABILITIES

INTRODUCTION

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

- Property and equipment
- Real estate or other assets acquired in satisfaction of members' loan obligations
- National Credit Union Share Insurance Fund deposits or other share insurance deposits
- Accounts receivable
- Prepaid expenses
- Payroll deductions receivable
- Investment in data service centers
- Investment in and loans to service organizations
- Monetary control reserve deposits
- Accrued income accounts

10.2 The following items may constitute other liabilities in a credit union —

- Accounts payable
- Accrued interest payable
- Accrued expenses
- Liability for consigned items sold
- Borrowers' taxes and insurance escrows
- Suspense accounts

ACCOUNTING PRINCIPLES: MEASUREMENT AND DISCLOSURE

Other Assets

10.3 *Property and Equipment*. This category includes land, buildings, furniture and equipment, leasehold improvements, and leased assets.

10.4 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 only if it is necessary or incidental to their operations. Credit unions are limited by regulatory authorities to a maximum investment in property and equipment. This limitation also includes lease payments. They may also be prohibited from acquiring real property from certain related parties.

10.5 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).

10.6 Credit unions may use any generally accepted method for calculating depreciation on property and equipment.

10.7 Property and equipment are normally presented 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, they should be reported separately in the statement of financial condition or in the notes to the financial statements. In either case the basis of valuation should be disclosed 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.

10.8 Lease commitments should be disclosed in the financial statements in accordance with FASB Statement No. 13, as amended.

10.9 The total estimated cost of a major expansion program and the unused amounts of related commitments should be disclosed in notes to the financial statements if the amounts are material.

10.10 *Assets Acquired in Settlement of a Loan*. The AICPA Accounting Standards Executive Committee has issued a proposed statement of position, *Accounting for Foreclosed Assets*, that would require real estate acquired through foreclosure to be classified in the statement of financial condition as held for sale and recorded at the lower of cost or fair value, reduced by the estimated cost to sell the asset.[26] The cost of the asset is represented by the fair value, as defined in FASB Statement No. 15, of the asset at the date of foreclosure plus cash payments for capital additions and improvements to the asset less accumulated depreciation and, if applicable, related interest subsequent to the date of foreclosure. Any excess of the cost of the asset over its fair value, increased by the estimated cost to sell the asset, should be reported as a valuation allowance; if the fair value of the asset subsequently increases, the valuation allowance should be reduced; increases or decreases in the valuation allowance should be charged or credited to income, as appropriate.

10.11 FASB Statement No. 15 defines *fair value* as the amount in cash or cash equivalent value of other consideration that a real estate parcel would yield in a current sale between a willing buyer and a willing seller — that is, other than in a forced liquidation sale. Its fair value should be measured by its market value if an active market for it exists. If an active market does not exist, FASB Statement No. 15 requires the fair value of the item to be estimated based on selling prices of similar items in active markets or, if there are no active markets for similar items, using a discounted forecast of expected cash flows at a rate commensurate with the risk involved (derived value).

[26] The final audit and accounting guide will incorporate the final conclusions of AcSEC's proposed statement of position on foreclosed assets.

10.12 *Acquisition, Development, and Construction Loans*. Credit unions have increasingly been entering into real estate acquisition, development, and construction loans in which the credit unions have virtually the same risks and potential rewards as those of the owners or joint venturers. These arrangements tend to expose a credit union to greater risk than normal lending arrangements and, as such, require careful analysis by the auditor. In some instances, accounting for such arrangements as loans is not appropriate, and investment or joint-venture accounting should be applied. The 1986 AcSEC Notice to Practitioners, *ADC Arrangements*, on accounting for real estate acquisition, development, or construction arrangements of financial institutions provides guidance in this area.

10.13 *National Credit Union Share Insurance Fund Deposit*. A federally insured credit union is required to maintain on deposit with the NCUSIF an amount equal to 1 percent of the credit union's total shares. The amount on deposit is adjusted for changes in the amount of a credit union's insured shares; if the insured shares decline, a pro rata portion of the amount on deposit with the NCUSIF is refunded to the credit union. A credit union also is required to pay an annual insurance premium equal to one-twelfth of 1 percent of its insured shares, unless the payment is waived or reduced by the NCUA Board.

10.14 The amount deposited with the NCUSIF should be accounted for and reported as an asset as long as the amount is fully refundable. When the refundability of a deposit is evaluated, the financial condition of the credit union and of the NCUSIF should be considered. A deposit is returned to a solvent credit union if its insurance coverage is terminated, it converts to insurance coverage from another source, or operations of the insurance fund are transferred from the NCUA Board. An insolvent or bankrupt credit union is not entitled to a return of its deposit. To the extent that the amount is not refundable, it should be expensed in the period in which the deposit is made or the asset becomes impaired.

10.15 In any year that the equity of the NCUSIF exceeds "normal operating levels," the NCUA Board is required to make distributions to insured credit unions to reduce the equity to normal operating levels. The distribution may be in the form of a waiver of insurance premiums, premium rebates, or cash payments.

10.16 The system of savings account insurance established by the recapitalization of the NCUSIF, which provided for reserves of 1 percent of insured deposits, is based on the concept that the required deposits create a fund with an earning potential sufficient to provide for the risk of losses in the credit union system. In years that the earnings of the fund have been adequate to provide insurance protection and cover all expenses and losses incurred by the fund, the NCUA Board has elected to waive the insurance premiums due from insured credit unions. In those years, it is industry practice to net the imputed earnings on the insurance deposit against the imputed premium expense rather than present them as gross amounts on the statement of income. Payments received in connection with the reduction in the equity of the NCUSIF should be reported as current-period income. Insurance premiums should be expensed when assessed by the NCUA Board.

10.17 *Credit Union Service Organizations*. Credit unions may have equity investments in or loans to affiliated companies that are generally referred to as *credit union service organizations* (CUSOs). The permissible amount of investment in or loans to CUSOs is governed by federal or state regulations.

10.18 In accordance with APB Opinion 18, the equity method should be used to account for a credit union's investment in a CUSO if the credit union has the ability to exercise significant influence over operating and financial policies of the CUSO. Subsidiaries should be included in the consolidated financial statements of the credit union in accordance with FASB Statement No. 94 and Accounting Research Bulletin No. 51.

10.19 *Accrued Interest Receivable*. Interest receivable on loans and investments should be accrued and reported as of the financial statement date. A credit union's policy for accruing interest on nonperforming loans should be disclosed in the notes to the financial statements.

10.20 *Other Assets*. This caption includes all assets not specifically listed elsewhere. Consideration should be given to reclassifying certain items from this caption to a more appropriate category. In addition, items that are individually material in amount should be presented separately. Items classified as other assets are generally presented last in the assets section of the statement of financial condition.

Other Liabilities

10.21 *Accounts Payable*. Accounts payable in a credit union typically consist of routine operating expenses similar to those of other business enterprises. In addition, accounts payable may include a liability for unclaimed or dormant share accounts and unpresented checks. State escheat laws may require that these amounts be remitted to the state after a specified period.

10.22 *Accrued Interest Payable*. Accrued interest payable is often a significant liability unless interest is paid on the financial statement date. Although federal law, and some state statutes, prohibit declaring interest until the end of the dividend period, a liability for interest earned by the share account holders should be recognized at each financial statement date.

10.23 *Accrued Expenses*. Other payables, such as payroll taxes withheld or consignments sold, should be accrued and reported at the amount withheld or collected but not yet remitted. Other accruals, such as those for employee sick and vacation time, excess pension plan obligation over pension plan assets (calculated in accordance with FASB Statement No. 87, *Employers' Accounting for Pensions*), or other postretirement benefits (calculated in accordance with FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*) should be accrued and reported using management's best estimate of the amount.

10.24 *Suspense Accounts*. Suspense accounts frequently include unposted payroll deductions, unposted share drafts, or other unapplied electronic items such as automated-teller-machine, electronic-funds-transfer (EFT), or automated-clearinghouse (ACH) transactions. Although recorded as liabilities in the general ledger, these accounts sometimes have debit balances.

10.25 *Other Liabilities*. This caption includes all liabilities not specifically listed elsewhere. Consideration should be given to reclassification of certain items from this caption to a more appropriate category in the statement of financial condition, if material. In addition, items that are individually significant in amount should be presented separately. Items classified as other liabilities are generally presented last in the liabilities section of the statement of financial condition.

AUDIT OBJECTIVES AND PROCEDURES

Audit Objectives

10.26 _Other Assets_. The primary audit objectives for other assets are to determine that —

- The assets exist and are owned by the entity.
- The assets are recorded at the proper amount.
- The assets are properly classified in the financial statements, and any encumbrances are disclosed.

10.27 _Other Liabilities_. For other liabilities, the primary audit objectives are to determine that —

- The liabilities represent authorized obligations.
- All contingencies and estimated future expenses that should be accrued during the period have been accrued, classified, and described in accordance with generally accepted accounting principles.

Planning Considerations

10.28 Statement on Auditing Standards No. 47, *Audit Risk and Materiality in Conducting an Audit*, requires the auditor to consider audit risk at the individual account-balance or class-of-transactions level.

10.29 _Other Assets_. The "other assets" of many credit unions are relatively insignificant when compared to total assets. However, when planning the audit of other assets, the auditor should consider such factors as —

- The amount of property and equipment purchases.
- The existence of any real estate or other assets acquired in satisfaction of members' loan obligations.
- Economic and environmental conditions and trends that affect the real estate market, and the age and quality of appraisals used to determine market value, if the credit union holds any real estate acquired in satisfaction of members' loan obligations.
- Changes in methods of recording other assets.
- Changes in client personnel assigned responsibility for the other asset area.

10.30 _Other Liabilities_. The "other liabilities" of many credit unions are relatively insignificant when compared to total liabilities. However, when planning the audit of other liabilities, the auditor should consider such factors as —

- The frequency of interest (dividend) payment periods, and how they correlate to the audit date.
- The credit union's employment policies, particularly as they relate to retirement plans, postretirement benefits, and the carryover of sick and vacation time.

- Whether or not new services have been instituted, including selling consignments or offering share drafts.
- Significant increase in mortgage loans with corresponding escrow accounts.

Internal Control Structure

10.31 Key internal control elements in the other assets and other liabilities areas include —

- Maintenance of adequate subsidiary ledgers, which should be periodically reconciled to the general ledger.
- Established procedures for the review of subsidiaries to determine the validity of recorded balances as of the financial statement date.
- Adequate segregation of duties.

10.32 In addition, proper internal control structure policies and procedures should provide for approval for property and equipment purchases, physical inventory of property and equipment, and prompt and accurate recording of authorized expenditures.

Substantive Tests

10.33 *Other Assets*. Substantive audit tests for property and equipment include —

- Examining supporting documents for major additions, sales, retirements, and other adjustments to carrying value.
- Conducting a physical observation of significant items.
- Examining deeds and title insurance policies.
- Reviewing insurance policies and coverage.
- Determining compliance with capitalization policy.
- Testing the computation of depreciation amounts.
- Determining compliance with regulatory property and equipment-investment limitations.
- Testing compliance with provisions of lease contracts.

10.34 Substantive audit procedures for real estate and other assets acquired in settlement of a loan include —

- Reviewing management's support for fair market value.
- Inspecting properties, observing such items as the overall stage of completion or overall deterioration of completed properties held for sale, and determining whether such properties are rented.
- Testing for proper classification.

10.35 *Use of the Work of Real Estate Appraisers*. The AICPA *Guide for the Use of Real Estate Appraisal Information* and SAS No. 11, provide standards on using the work of real estate appraisers. Appraisals are the products of work by people trained in appraisal principles and techniques. Appraisals by independent appraisers may be considered acceptable audit evidence. The quality of appraisals may vary, however, and in some instances, the auditor may have reason to believe that certain appraisals are unrealistic. The independent auditor should understand and

consider the approaches and assumptions used in obtaining the appraised value. Some matters that should be considered by the auditor when evaluating an appraisal are —

- *The Date of the Appraisal.* Real estate markets are constantly changing because of a variety of economic factors. Accordingly, a rise or decline in a particular market area not reflected in an appraisal may warrant that additional procedures or, perhaps, a new appraisal be performed. If the date of the appraisal is substantially earlier than the audit date, a rise or decline in a particular market area between the two periods may warrant a new appraisal or the performance of additional procedures.
- *The Basing of Appraisals on Cost.* Buildings may be recorded at less than current cost but may actually be worth less than book value.
- *The Basing of Appraisals of Uncompleted Projects on Values When Completed.* Appraised values should be based on current market conditions and must be discounted for costs to complete and sell, as well as carrying costs. The estimated selling prices should reflect the expectations of a sale in the reasonably near future — not in an indefinite future period.

10.36 Because of time and cost considerations, a credit union may use various approaches to estimate value without using the services of an independent appraiser. In evaluating internally derived valuation data as audit evidence, the auditor should understand the methods and assumptions used and be aware of inherent subjective determinations in estimating value that may be significant to the valuation process. The auditor should consider the reasonableness of the assumptions and approach used and test the information underlying the valuation. The auditor may decide to engage an appraiser independent of the credit union to test the credit union's internally derived valuation. Additional guidance is provided by the *Guide for the Use of Real Estate Appraisal Information.*

10.37 Audit procedures for other assets include —

- Examining evidence supporting the carrying amount of other assets, including such items as an actuarial evaluation used to compute prepaid pension costs, or the financial statements of a CUSO or data service center in which the credit union has invested.
- Sending confirmation requests, as appropriate.
- Inspecting real estate or reviewing applicable appraisals and legal documents for foreclosed property.
- Testing calculations of amortization of prepaid assets.

10.38 Other Liabilities. Audit procedures for dividends or interest payable or accrued include —

- Tracing recorded amounts to data-processing reports.
- Agreeing rates used in the calculation of recorded amounts to board of directors' approval.
- Testing a sample of individual calculations from the accrued interest (dividends) report.
- Reconciling recorded liabilities as of the audit date to amounts actually paid in the subsequent period.
- Calculating the yield of recorded balances of members' shares and savings accounts and agreeing the result to the rates approved by the board of directors.

10.39 For other liability amounts, audit procedures include —

- Closely examining items classified as suspense. If material, these items may be more appropriately reclassified from suspense to their related accounts.
- Examining evidence supporting the carrying amount of other liabilities, including such items as an actuarial evaluation used to compute accrued pension costs, payroll tax returns, and invoices received from third parties.
- Sending confirmation requests, where appropriate.
- Recalculating other recorded accruals.
- Performing a search for unrecorded liabilities.

Chapter 11

EQUITY

INTRODUCTION

11.1 Credit unions operate under a cooperative form of ownership. Members, in effect, "own" the credit union, although their interests in the credit union (shares) have the characteristics of deposits. The equity section of a credit union's statement of financial condition generally consists only of retained earnings. Retained earnings includes undivided earnings, statutory reserves, and other appropriations as designated by management or regulatory authorities. Although credit unions may be incorporated, no stock is issued. Shares, share drafts, share certificates, and other forms of members' deposits, although often defined as equity by regulatory authorities, are deposits and should be shown as liabilities on the statement of financial condition.

ACCOUNTING PRINCIPLES: MEASUREMENT AND DISCLOSURE

Undivided Earnings

11.2 The accounting for transactions in undivided earnings is similar to that of other enterprises. Common transactions include increases and decreases to close net income and losses at the end of the accounting period. These closing transactions, unlike those of most other enterprises, often occur on a quarterly basis. The undivided earnings is also increased and decreased for transfers to and from appropriated accounts such as the regular reserve. Undivided earnings, therefore, represent unappropriated accumulated earnings or losses of the credit union since its inception.

Regular Reserve (Statutory Reserve)

11.3 The regular reserve account represents a regulatory appropriation of equity. The Federal Credit Union Act and certain states require that this account be established and maintained to provide an equity base for credit unions.

11.4 The account is established through a charge to undivided earnings and a credit to the regular reserve. For federal credit unions, the amount of the transfer is defined in section 1762 of the *Federal Credit Union Act* and further addressed in section 700.1 of the NCUA *Rules and Regulations*. A designated percentage of gross income is transferred at the end of each accounting period. The percentage is determined based on the relationship of irrevocable reserves — which, for transfer-calculation purposes, include both the regular reserve and the allowance for loan losses, reduced by the balance in the provision for loan losses account — to total risk assets.[27] This relationship is stated as a percentage that is used to determine the amount to be transferred. The board of directors may, at its discretion, transfer more to the regular reserve than the regulatory requirement described previously.

11.5 It should be noted that the previously described transfer requirements apply to federal credit unions. Certain states may adopt similar regulations. The statutes for each state should be consulted for applicable requirements.

[27] Risk assets are defined in section 700.1(j) of the NCUA Rules and Regulations by listing those assets that are to be excluded from the calculations of risk assets.

11.6 The regular reserve is not a substitute for the allowance for loan losses, but is a regulatory restriction of undivided earnings. Loan losses and the provision for loan losses should not be charged directly to the regular reserve, but should be accounted for as described in chapter 6.

Appropriated Undivided Earnings

11.7 The board of directors may restrict an amount of undivided earnings for specific purposes. Examples include appropriations for loss contingencies and major expenditures. The amount of the appropriation is normally transferred from undivided earnings, pending resolution of its purpose. The amount would normally be returned to undivided earnings when no longer deemed necessary.

11.8 Occasionally, there are instances in which a credit union receives a donation of an asset of material value. The donation should be recognized as revenue in the period received and should be recorded to the appropriate asset account. The transaction should generally be recorded based on the fair market value of the asset at the date of donation. The fair value can be estimated by referring to quoted market prices, prices in transactions involving the same or similar assets, independent appraisals, and other evidence. However, a major uncertainty about the existence of value may indicate that an item received is not an asset and should not be recognized. This accounting treatment is consistent with the FASB's exposure draft, *Accounting for Contributions Made and Capitalization of Works of Art, Historical Treasures, and Similar Assets*. Readers should be alert for the issuance of final accounting standards issued by the FASB in this area.

11.9 A credit union may be required to report an unrealized loss from temporary declines in the values of investments in marketable equity securities as part of equity in accordance with FASB Statement No. 12. This account is the offset of the contra asset established to write down temporary declines of investments to their realizable value. Permanent declines in investments should be charged directly to operations.

Financial Statement Presentation

11.10 Retained earnings generally is shown as a single line item on the statement of financial condition. Alternatively, the components of equity may be presented in the body of the statement of financial condition, the notes to the financial statements, or the statement of retained earnings. All restrictions of retained earnings should be disclosed. Typical restrictions include regulatory restrictions (regular reserve), discretionary restrictions, and those imposed by credit or other agreements.

AUDIT OBJECTIVES AND PROCEDURES

Audit Objectives

11.11 The primary audit objectives for equity are to determine that —

- Balances and transactions are properly stated and classified.
- Balances and transactions are recorded at proper amounts in the appropriate accounting period and presented in the financial statements in conformity with generally accepted accounting principles.

Auditing Procedures

11.12 The auditor should be familiar with the reserve requirements of the applicable federal and state laws and regulations.

11.13 In the event of reserve or undivided earning deficiencies, the credit union may be limited in matters such as payment of interest (dividends) or acquisition of significant assets. These limitations may require the establishment of special reserves, or, in severe instances, the merger or liquidation of the credit union.

11.14 The auditor should be satisfied that regular reserve transfers have been made in accordance with regulatory requirements. Other entries, including direct charges and credits in accordance with regulatory requirements, should be tested for propriety.

Chapter 12

COMPUTER PROCESSING

INTRODUCTION

12.1 Nearly all credit unions use computers to some extent in processing accounting data. The size and complexity of a credit union, coupled with the variety of services that it provides, determine the extent to which computer-processing applications are used.

12.2 The most common computer applications in credit unions are in the loan-processing and share-transactions-processing areas. Other widely used applications include the processing of payroll and general ledger/journal entry information. Credit union computer systems are often fully integrated and on-line real time. Accordingly, all major applications are often automated once a computer system is installed.

12.3 As credit unions venture into other services, additional computer-processing applications are usually introduced as well. Such services may include (*a*) access to automated teller machines, (*b*) credit cards, (*c*) share drafts and debit cards with remote access to member share accounts, (*d*) access to automated clearinghouse services, (*e*) telephone bill paying and voice-response systems, and (*f*) direct deposit of payroll checks.

12.4 Computer operations may be performed solely by the credit union, shared with others, or provided by an independent organization that supplies specific data-processing services for a fee. Integration of computer processing into a credit union environment may occur in several different ways. The means of integration will vary, depending on the size and sophistication of the credit union and the applications processed by computer. Some of the more common ways in which computer operations become integrated on a credit union's operating environment include the following:

- *Service bureaus* are vendors with significant data-processing experience and equipment capacity that have written software for particular applications and service. Service bureaus sell data-processing time on their systems to individual credit unions. This is usually the easiest and lowest cost method used by credit unions to obtain computer-processing services. It requires the smaller in-house commitment in terms of dedication of capital, physical requirements, and personnel resources. The use of service bureaus is most common in very small and less sophisticated credit unions, and by credit unions that branch out into more extensive service lines such as ATMs, share drafts, and credit cards. Some service bureaus are privately owned; others are credit union service organizations. *Information systems processing CUSOs* are an offshoot of the service bureau concept in that ownership and maintenance of the hardware and software lies with an entity outside the credit union. The major difference between CUSOs and privately owned service bureaus is that the CUSO is owned by a group of credit unions. An individual credit union may or may not be a partial owner of this shared facility. Another difference lies in the fact that the CUSO is dedicated to processing transactions for credit unions exclusively rather than to serving many types of clients with various product lines. Generally, the CUSO is an amalgamation of smaller credit unions attempting to benefit from the economies of scale frequently found in larger operations.

- *Facilities-management agreements* may vary in some aspects, but generally, the credit union owns its own hardware and software, and contracts with an outside firm for the personnel required to operate the system. This requires capital outlays by the credit union, but provides the credit union with the opportunity to control costs, equipment, and data without maintaining additional in-house staff.

- *Turnkey operations* are characterized by in-house hardware systems with outside software development and support. Under a turnkey operation arrangement, the individual credit union assumes responsibility for system operation and maintenance, backup and recovery, contingency planning, security, and data-field integrity. Turnkey operations usually operate on powerful personal computers (PCs) or minicomputers. Generally, a vendor sells the hardware and software together in one complete package. This alternative is very popular, primarily with medium to large credit unions.

- *In-house processing* is performed on hardware and internally developed, purchased, or maintained software operated by credit union employees. The addition of internal software development and maintenance is a significant undertaking. The benefits of the flexibility provided by customized software are countered by increased resource requirements, including the addition of specialized personnel to design, write, test, and maintain the software. Historically, the significant financial commitment required by this alternative allowed only the largest credit unions to choose this option. Low-cost PCs may make this an attractive option for some very small credit unions; however, the cost of developing and maintaining custom software must be carefully considered before choosing this option.

AUDIT OBJECTIVES AND PROCEDURES

Audit Objectives

12.5 The audit objectives related to accounting applications that are processed by computer do not differ significantly from the objectives related to the applications when they are processed manually.

Internal Control Structure

12.6 When a credit union has significant computerized accounting applications, the auditor should obtain an understanding of both the manual and the computerized aspects of the internal control structure. SAS No. 55 provides guidance that is relevant to both manual and computerized aspects of the internal control structure. The auditor may also refer to the AICPA Audit Guide *Consideration of the Internal Control Structure in a Financial Statement Audit.*

12.7 Service Bureaus — Third-Party Reviews. When significant reliance is placed on information processed through an outside vendor, such as a service bureau or CUSO, the auditor should consider the guidance provided by SAS No. 70.

Reference Materials

12.8 Guidance in auditing records when computer processing is significant is contained in the following documents:

- SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*
- SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*

- AICPA Audit and Accounting Guide *Computer-Assisted Audit Techniques*
- AICPA Audit Guide *Consideration of the Internal Control Structure in a Financial Statement Audit*.

Other organizations also have produced documents that the auditor may wish to consult. These include the Federal Financial Institutions Examination Council's *EDP Examination Handbook*, which includes a section titled "Internal and External EDP Audit."

Chapter 13

BUSINESS COMBINATIONS

INTRODUCTION

13.1 Business combinations involving credit unions are becoming more prevalent. They result from voluntary decisions as well as from regulatory mandate. This chapter discusses relevant accounting issues pertinent to business combinations in the credit union industry.

ACCOUNTING PRINCIPLES: MEASUREMENT AND DISCLOSURE

13.2 The primary guidance on accounting for business combinations involving credit unions is found in the following pronouncements:

- APB Opinion No. 16, *Business Combinations*
- APB Opinion No. 17, *Intangible Assets*
- FASB Statement No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions*
- FASB Interpretation No. 9, *Applying APB Opinion Nos. 16 and 17 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method*
- FASB Technical Bulletin No. 85-5, *Issues Relating to Accounting for Business Combinations.*
- Various FASB EITF consensuses including, but not limited to, Consensus No. 88-19, *FSLIC-Assisted Acquisitions of Thrifts*

13.3 APB Opinion No. 16 applies to business combinations of credit unions. The purchase method and the pooling of interest method are both acceptable in accounting for business combinations of credit unions, although not as alternatives for accounting for the same business combination. A business combination that meets the conditions specified in APB No. 16 should be accounted for using the pooling of interests method. A new basis of accounting is not permitted for a combination that meets the specified conditions, and the assets and liabilities of the combining companies are combined at their recorded amounts. All other business combinations should be accounted for using the purchase method. Regulatory-assisted business combinations do not meet the criteria in APB No. 16 for a pooling of interest.

13.4 In transactions accounted for using the purchase method, goodwill may arise from the value of liabilities assumed or the consideration paid (if any), or both. The excess of the fair value of liabilities assumed over the fair value of tangible and identifiable intangible assets acquired constitutes an unidentifiable intangible asset (goodwill). FASB Statement No. 72 established authoritative standards on amortizing goodwill in purchase transactions when the fair value of liabilities assumed exceeds the fair value of tangible and identifiable intangible assets acquired. Goodwill arising from the payment of additional consideration in a purchase transaction (other than the assumption of liabilities) should be accounted for in accordance with APB Opinion No. 17 or, if certain factors are present, in accordance with FASB Interpretation No. 9.

13.5 A forty-year amortization period for goodwill arising from the acquisition of a credit union, other than the portion of goodwill accounted for in accordance with FASB Statement No. 72, may be excessive. APB Opinion No. 17 requires annual evaluation of the amortization period of such goodwill. Generally, the credit union's management must evaluate all of the salient facts underlying a proposed combination to determine the propriety of the accounting method to be applied.

13.6 The NCUA generally does not allow the recognition of goodwill in a business combination, which may result in a GAAP/RAP difference.

NCUSIF-Assisted Acquisition of Credit Unions

13.7 FASB EITF Consensus No. 88-19 addresses situations in which a savings institution is acquired pursuant to an assistance agreement (agreement) between the acquirer and the Federal Savings and Loan Insurance Corporation (FSLIC). (Since the date of this consensus, the FSLIC was dissolved by FIRREA; however, the guidance provided in that consensus remains appropriate and can be applied to all regulatory-assisted acquisitions, including those involving the NCUSIF.)

13.8 Under an agreement, the acquirer may receive cash from the NCUSIF, which typically equals the amount by which the fair value of the credit union's liabilities exceeds the fair value of its assets. The assistance provided by the NCUSIF under an agreement may include *(a)* reimbursement (of up to 100 percent) if covered assets are ultimately collected or sold for amounts that are less than a specified amount during a specified period of time and *(b)* indemnification against certain loss contingencies.

13.9 FASB EITF Consensus No. 88-19 also addresses how the acquirer should account for contingency losses and for the reimbursement of those losses by the NCUSIF under the indemnification provisions of an agreement (including losses and reimbursements that occur after the expiration of the purchase price allocation period). Losses resulting from contingencies related to the acquisition that are covered by the indemnification provisions of an agreement should be recognized by the acquirer net of the reimbursement received or receivable from the NCUSIF under the agreement.

13.10 Users of financial statements must be able to assess the impact of credit and other risks on a credit union following a regulatory-assisted acquisition, transfer, or other reorganization on a basis comparable to that disclosed by other credit unions, that is, as if the assistance did not exist. In that regard, the amount of regulatory assistance should be disclosed.

AUDIT OBJECTIVES AND PROCEDURES

Audit Objectives

13.11 The primary objectives in auditing a business combination are to determine that —

- The transaction is appropriately accounted for as a pooling or a purchase.
- The values assigned to the assets and liabilities of the acquired credit union in a purchase accounting transaction represent the fair values.
- Any goodwill arising from a purchase transaction is amortized over an appropriate period of time.
- Any NCUSIF assistance received to facilitate the purchase is appropriately accounted for.

Internal Control Structure

13.12 Typical internal control structure policies and procedures relating to business combinations include the following:

- Accounting entries made to record the transaction initially and those required in subsequent years are reviewed by supervisory personnel to ensure accuracy.
- Subsequent to acquisition, the assumptions used in assigning values to assets and liabilities are reviewed by management for continuing validity.

Substantive Tests

13.13 The nature, timing, and extent of substantive tests should be determined based on the auditor's understanding of the internal control structure of business combinations and the assessment of control risk in this area. Usually the auditor assesses control risk at the maximum and takes a substantive approach to the examination of business combinations in the year of acquisition.

13.14 The auditor should be satisfied with the supporting documentation underlying the fair value assigned to an acquired credit union's assets and liabilities. Virtually all of a credit union's significant asset and liability classifications can be supported by independent third-party appraisals, for example, office premises and equipment, other real estate, the loan portfolio, fair value of certificates of deposit, and core deposit values. SAS No. 11 and the AICPA *Guide for the Use of Real Estate Appraisal Information* provide guidance on the auditor's considerations in using the work of specialists, such as appraisers. The auditor should consider the need for asking the credit union's management to engage appraisers to determine the propriety of any significant assigned carrying values that are unsupported by independent appraisals.

13.15 The assumptions should be reasonable, and particular attention should be focused on assumptions concerning the assessment of credit risk, loan prepayment factors, and the interest rate assigned in relation to current market conditions.

13.16 In certain instances, regulators may agree to provide financial assistance to a credit union in order to facilitate a purchase transaction. FASB Statement No. 72 states that if the receipt of the assistance is probable and reasonably estimable at the date of acquisition, that portion of the cost of the acquired credit union shall be assigned to the amount of such financial assistance to be received. If the financial assistance is to compensate for interest-rate margins, the assistance is to be considered as additional interest on the interest-bearing assets acquired in determining their fair value. There should be a reduction in recorded goodwill for any assistance subsequently received that had not been considered because such assistance was not probable or the amount was not reasonably estimable at the date of acquisition.

13.17 Subsequent to an acquisition, the auditor should periodically review the continuing validity of the assumptions used in assigning values to assets and liabilities. The auditor should consider a credit union's ability to recover the value of unidentifiable intangible assets recorded in the acquisition. Uncertainty about a credit union's ability to continue in existence may result in a significant impairment of the value originally ascribed to goodwill.

Chapter 14

STATEMENT OF CASH FLOWS

INTRODUCTION

14.1 The illustrative financial statements in Appendix A include a statement of cash flows presented in accordance with FASB Statement No. 95, *Statement of Cash Flows*. The statement of cash flows classifies cash receipts and disbursements into three broad categories: operating cash flows, investing cash flows, and financing cash flows. FASB Statement No. 95 provides broad guidelines for making these classifications. Cash flows are generally required to be presented on a gross basis, although certain cash flows may be presented on a net basis.

OPERATING CASH FLOWS

14.2 FASB Statement No. 95 sets forth two methods of reporting cash flows from operating activities; the direct method is encouraged but not required. Under the direct method, the statement of cash flows reports the net cash flow from operating activities by showing the major classes of gross cash receipts (such as interest received and service charges collected) and gross cash disbursements (such as interest paid and operating expenses paid). If the direct method is used, FASB Statement No. 95 requires the presentation of a separate schedule to reconcile net income to the net cash flow from operating activities.

14.3 In contrast, a statement of cash flows prepared using the indirect method reports net cash flow from operating activities by adjusting net income for transactions reflected in net income that do not result in operating cash flows. A similar reconciliation approach was widely used in practice in presenting the statement of changes in financial position. If the indirect method is used, FASB Statement No. 95 requires separate disclosure of interest paid (other than interest capitalized).

14.4 FASB Statement No. 102, *Statement of Cash Flows — Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*, amended FASB Statement No. 95 by providing, among other things, that cash receipts and cash payments that result from purchases and sales of securities are to be classified as operating cash flows if the securities are carried at market value in a trading account. Similarly, cash receipts and cash payments that result from loans originated or purchased specifically for resale are also to be classified as operating cash flows if such loans are carried at market value or at the lower of cost or market value. When FASB Statement No. 102 is applied using the direct method, the gross cash receipts and cash payments from these sources would be separately reported in the operating cash flows section of the statement. If the indirect method is used, only the net increases or decreases in these loans and securities would be reported in reconciling net income to the net cash flow from operating activities.

INVESTING AND FINANCING CASH FLOWS

14.5 Cash flows from investing and financing activities must generally be reported on the basis of gross cash receipts and gross cash disbursements. However, FASB Statement No. 95 permits the net basis of reporting for the following:

- Cash and cash equivalents (discussed below)
- Items for which turnover is quick, amounts are large, and maturity is short; these items are limited to those with an original maturity of three months or less, such as:
  - Investment securities not included in cash equivalents
  - Loans (including demand loans and credit card loans)
  - Certificates of indebtedness
  - Borrowings
- Items for which the credit union is substantively holding, receiving, or disbursing cash on behalf of its members, such as:
  - Share draft accounts
  - Savings deposits
  - Money market deposit accounts
  - Mortgage escrow funds
  - Collections and remittances on loans serviced for others

14.6 A summary of the typical investing and financing cash flows for a credit union follows.

Investing Activities

Cash Inflows	Cash Outflows
Loan principal payments	Loan originations
Loan sale proceeds	Loan purchases
Investment security sale and maturity proceeds	Investment security purchases
Real estate sale proceeds	Investments in foreclosed real estate

Financing Activities

Cash Inflows	Cash Outflows
Net increase in mortgage escrow deposits	Net decrease in mortgage escrow deposits
Certificates of deposit issued	Certificates of deposit matured
Net increase in other deposit accounts	Net decrease in other deposit accounts
Other borrowings proceeds	Repayment of other borrowings
Net increase in short-term borrowings (original maturity of three months or less)	Net decrease in short-term borrowings (original maturity of three months or less)
	Dividends and other cash distributions to members

14.7 FASB Statement No. 104, *Statement of Cash Flows — Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions*, amended FASB Statement No. 95 to permit financial institutions to report net cash receipts and cash payments for (*a*) deposits placed with other financial institutions and withdrawals of those deposits, (*b*) time deposits (certificates of deposit) accepted and repayments of those deposits, and (*c*) loans originated and principal collections on such loans. Detailed information about loan originations and repayments is often readily available in credit unions. The auditor should consider reporting gross cash receipts and cash payments for loans if it would provide more meaningful information to financial statement users. FASB Statement No. 104 also provides that cash flows from a forward contract, futures contract, options contract, or swap contract that is accounted for as a hedge be classified consistently with the classification of the cash flows from the item being hedged. Cash flows from nonhedge instruments should be classified based on the nature of the instrument.

NONCASH INVESTING AND FINANCING ACTIVITIES

14.8 Investing and financing activities that are partially or fully noncash transactions must be reported in a related disclosure either (*a*) in narrative form in the notes to the financial statements or (*b*) in a schedule presented together with the statement of cash flows. Examples of noncash investing and financing activities for a credit union include —

- Origination of a mortgage loan to finance the sale of foreclosed real estate.
- Acquisition of a real estate property through foreclosure of the related mortgage loan.
- Acquisition of assets under capital leases.
- Acquisition of another credit union using the purchase method of accounting. Only the cash paid in the acquisition (net of cash acquired) would be reported as a cash outflow from an investing activity; information concerning the fair value of assets acquired and liabilities assumed would be presented in the supplemental disclosure of noncash activities.
- Chargeoffs and transfers of loans and related fees.

DEFINITION OF *CASH AND CASH EQUIVALENTS*

14.9 The statement of cash flows displays the net change during the period in cash and cash equivalents. The beginning and ending amounts of cash and cash equivalents in the statement of cash flows should agree with the amount shown for similarly titled line items or subtotals in the statement of financial condition.

14.10 Because of the flexibility in classification, FASB Statement No. 95 requires disclosure of the policy used to classify items as cash equivalents. This disclosure is generally included in the accounting policy footnote. A change in this policy is a change in accounting principles that requires restatement of prior years' financial statements presented for comparative purposes.

Chapter 15

AUDITOR'S REPORTS

INTRODUCTION

15.1 When reporting on the financial statements of a credit union, the auditor follows the provisions of SAS No. 58. This chapter discusses the unique reporting issues that an auditor may encounter in the credit union industry, including the classification of member shares as capital and the issuance of various required regulatory and other compliance reports.

REPORTS ISSUED BY CPAs

Standard Auditor's Report

15.2 The auditor's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with GAAP. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with GAAS. The following is an example of an auditor's standard report (unqualified opinion) on the financial statements of a credit union.

Independent Auditor's Report

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

We have audited the accompanying statements of financial condition of XYZ Credit Union as of December 31, 19X2 and 19X1, and the related statements of income, members' equity, and cash flows for the years then ended. These financial statements are the responsibility of the credit union'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 position of XYZ 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*]

[*City*]
[*Date*]

Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)

15.3 Section 701.13 of the NCUA *Rules and Regulations* requires certain federal credit unions to obtain an outside, independent audit by a CPA. Some state regulatory agencies also require independent audits of state-chartered credit unions. These regulatory agencies may require the use of a basis of accounting other than generally accepted accounting principles for financial statements prepared for regulatory purposes. For example, as discussed in paragraph 8.6, the NCUA requires federal credit unions to report members' shares as equity for regulatory purposes. SAS No. 62 defines an OCBOA and provides guidance on reporting on OCBOA financial statements.

15.4 The following is an example of an auditor's report on financial statements prepared in conformity with a comprehensive basis of accounting prescribed by the National Credit Union Administration in which, for example, members' shares are reported as equity:

<u>Independent Auditor's Report</u>

Board of Directors
XYZ Credit Union

We have audited the accompanying statements of financial condition — regulatory basis of XYZ Credit Union as of December 31, 19X2 and 19X1, and the related statements of income — regulatory basis, members' equity — regulatory basis, and cash flows — regulatory basis for the years then ended. These financial statements are the responsibility of the credit union'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.

As described in note X, these financial statements were prepared in conformity with the accounting principles prescribed or permitted by the National Credit Union Administration, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Credit Union as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in note X.

This report is intended solely for the information and use of the board of directors and management of XYZ Credit Union and for filing with the National Credit Union Administration, and should not be used for any other purpose.

[*Signature*]

[*Date*]

Members' Shares Reported as Equity

15.5 As discussed in paragraph 8.6, members' shares should be reported as liabilities in the statement of financial condition. Some credit unions, however, report members' shares as equity or, using an unclassified presentation, show all liabilities and equity together under one subheading. If members' shares are reported as such, unless the financial statements are prepared using a comprehensive basis of accounting other than GAAP (see paragraphs 15.3 and 15.4), the auditor should express a qualified opinion or, in certain cases, an adverse opinion on the financial statements if the members' shares are material to the financial statements. Illustrations of reports modified in those circumstances follow.

Qualified Opinion

[*Same first and second paragraphs as the standard report*]

The credit union has reported members' shares as equity in the accompanying statements of financial condition that, in our opinion, should be reported as liabilities in order to conform with generally accepted accounting principles. If these shares were properly reported, liabilities would increase and equity would decrease by $_____ and $_____ as of December 31, 19X2 and 19X1, respectively.

In our opinion, except for the effects of reporting members' shares as equity as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Credit Union as of 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.

Supervisory Committee Auditor's Report

15.6 The form and content of reports that are currently prepared by independent auditors in connection with supervisory committee audits reflect a diversity of practice. As a result, supervisory committee members may not understand the fundamental differences between an engagement for the application of agreed-upon procedures to specified elements, accounts, or items of a financial statement in connection with a supervisory committee audit and an audit of a credit union's financial statements in accordance with GAAS. This is of particular concern when the limitations of the supervisory committee audit relate to areas of higher risk in the credit union industry. Further, supervisory committee members may incorrectly assume that the application of agreed-upon procedures included obtaining an understanding of the credit union's internal

control structure similar to that obtained in an audit of the credit union's financial statements in accordance with GAAS.

15.7 Reports prepared by CPAs, based on audits of financial statements, should comply with the reporting provisions contained in applicable SASs. SAS No. 58 gives guidance on reports on audited financial statements, and paragraph 70 of that SAS states that a disclaimer of opinion is appropriate when the auditor has not performed an audit sufficient in scope to enable him or her to form an opinion on the financial statements.

15.8 Reports prepared by CPAs, based on performance of agreed-upon procedures in connection with a supervisory committee audit, should be prepared in conformity with paragraph 4 of SAS No. 35, *Special Reports — Applying Agreed-upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*, which states that they

> should (*a*) indicate the specified elements, accounts, or items to which the agreed-upon procedures were applied, (*b*) indicate the intended distribution of the report, (*c*) enumerate the procedures performed, (*d*) state the accountant's findings, (*e*) disclaim an opinion with respect to the specified elements, accounts, or items, and (*f*) state that the report relates only to the elements, accounts or items specified, and does not extend to the entity's financial statements taken as a whole.

A footnote to that paragraph adds the following information:

> When the accountant consents to the inclusion of his report on the results of applying agreed-upon procedures in a document or written communication containing the entity's financial statements, he should look to SAS No. 26, *Association With Financial Statements,* or to Statement on Standards for Accounting and Review Services (SSARS) No. 1, *Compilation and Review of Financial Statements,* as appropriate, for guidance on his responsibility pertaining to the financial statements.

SAS No. 35, paragraph 5, provides the following guidance:

> If the accountant has no adjustments to propose to the specified elements, accounts, or items, he may include a comment to that effect in his report. For example, the following language might be included: "In connection with the procedures referred to above, no matters came to our attention that caused us to believe that the (specified elements, accounts, or items) should be adjusted." Also, the accountant may wish to indicate that had he performed additional procedures with respect to the specified elements, accounts, or items or had he performed an audit of the financial statements in accordance with generally accepted auditing standards, (other) matters might have come to his attention that would have been reported.

15.9 As mentioned earlier, some regulatory agencies require that supervisory committee audit reports include financial statements or data. In such instances, the supervisory committee will usually include the CPA's special-purpose report and the unaudited financial statements or data.

15.10 A CPA may be requested to perform specific procedures while conducting a compilation or review of financial statements. The procedures employed in compilation and review engagements, and reports thereon, should comply with the provisions of SSARS No. 1. In accordance with SSARS No. 1, paragraph 32, any procedures that the accountant might have performed before or during the review engagement, including those performed in connection with

a compilation of the financial statements, should not be described in his or her report. This provision, however, would not preclude a CPA from issuing a separate, special-purpose report on the nature and extent of procedures performed in accordance with SAS No. 35.

15.11 The following is an example of a special report for agreed-upon procedures performed in connection with a supervisory committee audit.

> Supervisory Committee
> XYZ Credit Union
>
> We have applied certain agreed-upon procedures, as discussed in the attached supplement, to selected accounting records and transactions of the XYZ Credit Union as of [*audit date*]. These procedures were performed in accordance with the arrangements set forth in our letter to you dated [*date*].
>
> The procedures we performed, the accounts we examined, and the findings we obtained are summarized in the attached supplement, which is an integral part of this report. Because our procedures do not constitute an audit made in accordance with generally accepted auditing standards, we do not express an opinion on any of the accounts or items referred to in the supplement.
>
> In connection with the procedures referred to in the attached supplement, no [*the following*] matters came to our attention that caused us to believe that the specified [*the following*] account[s] should be adjusted. Had we performed additional procedures or had we conducted an audit of the financial statements in accordance with generally accepted auditing standards, matters might have come to our attention that would have been reported to you. The scope of the engagement also does not include an evaluation of areas that generally are of higher risk to the credit union, such as an evaluation of securities held or of the collectibility of loans, the adequacy of collateral thereon, or the reasonableness of the allowance for loan losses.
>
> This report relates only to the accounts and items specified in the attached supplement and does not extend to any financial statements of XYZ Credit Union taken as a whole.
>
> This report is intended solely for the use of management [*and specified regulatory agency or other specified third party*] and should not be used for any other purpose.
>
> ______________________________
> [*Signature of Independent Auditor*]
>
> [*City, State*]
> [*Date*]

Supplement to Illustrative Report
Loans

We obtained trial balances or subsidiary ledgers of the notes or both from the service center and reconciled the totals to the general ledger in the following amounts:

Account	Amount Outstanding at June 30, 19X0
Business loans	$
Consumer loans	
Real estate loans	
Participations purchased	
	$

Certain [*specify number*] loans, including lines of credit that had not been fully funded, were selected for confirmation directly with borrowers. The results of our confirmation efforts are summarized in Schedule A. Borrowers with lines of credit of $_____ or more as of June 30, 19X0, who did not respond to confirmation requests by July 31, 19X0, are listed in Schedule B.

We examined selected loans and loan agreements on hand, as well as readily marketable securities and other collateral recorded as held in respect of certain selected secured loans were inspected.

We obtained the Credit Union's listing of business loans, real estate loans, and participations purchased five days or more past due as of June 30, 19X0, and compared it to a similar listing as of July 31, 19X0. The following loans were listed in both reports:

[*List loans.*]

Similarly, we obtained the Credit Union's listing of consumer loans ten days or more past due as of June 30, 19X0, and compared it to a like listing as of July 31, 19X0. The following loans were listed in both reports:

Note: This supplement is for illustrative purposes only and, therefore, is not considered to be an all-inclusive list of accounts that may be examined and procedures that may be performed. The illustrative procedures listed may or may not be relevant to a particular engagement. The independent auditor should describe those accounts examined and procedures relevant to the specific engagement. The accounts and procedures described in the report should generally conform to those described in the engagement letter. Procedures for other accounts should be specified in detail, and differences and subsequent disposition should be reported.

Name	Due Date	Amount Outstanding at June 30, 19X0	Amount Outstanding at July 31, 19X0

Loan participations "sold" and serviced by the credit union were confirmed with the purchasers, without exception.

We obtained the Credit Union's listing of overdrafts as of June 30, 19X0, and compared it to a similar listing as of July 31, 19X0. The following overdrafts were listed in both reports:

Name	Date of Overdraft	Amount at June 30, 19X0	Amount at July 31, 19X0

The interest rates and repayment terms of five judgmentally selected loans granted to directors, officers, and other related parties during May 19X0 were compared to the interest rate and repayment terms of similar loans granted to outsiders during the same month. No instances of the granting of favorable interest rates or repayment terms to directors, officers, and other related parties were found.

The maturity date and amount of loan commitments in excess of $50,000 were confirmed as of May 19X0 by the customers for whose benefit they were issued, without exception. We judgmentally selected five loan commitments, and tested the computation of deferred fee income with satisfactory results.

Requests for confirmation of loan balances could not be mailed to the following borrowers due to lack of sufficient addresses:

Name	Account Number	Balance as of June 30, 19X0

Lack of Evaluation of Collectibility and Adequacy of Collateral

As noted in our engagement letter and report, we did not evaluate the collectibility of loans or the adequacy of collateral thereon.

Lack of Evaluation of the Allowance for Loan Losses

As noted in our engagement letter and report, we did not evaluate the reasonableness of the allowance for loan losses determined by management.

Confirmation Statistics
[Audit Date]

	Loans	Share Draft Accounts	Savings Accounts	Certificates of Deposit
Dollar amounts				
Total				
Circularized				
Percent circularized to total				
Replies received to total circularized				
Selected but not circularized				
Not delivered by post office				
Number of accounts				
Total				
Circularized				
Percent circularized to total				
Replies received				
Percent replies received to total circularized				
Selected but not circularized				
Not delivered by post office				

Confirmation Requests Not Mailed

	Name and Address	Reason for Not Mailing	Balance as of *[Audit Date]*
Loans			
Share draft accounts			
Savings accounts			
Certificates of deposit			

Note: An indication of how the samples were selected (that is, on a random, statistical, or judgmental basis), as well as an indication of the type of confirmation (that is, positive or negative requests), should be included. If the loans are categorized by type in the report, similar categories would normally be used in this schedule.

ILLUSTRATIVE CREDIT UNION FINANCIAL STATEMENTS

A.1 This appendix contains illustrative financial statements of a credit union. The illustrative financial statements do not include all of the amounts and transactions that might be found in practice; they are for illustrative purposes only. More or less detail should appear in the financial statements or in the notes, depending on the circumstances.

A.2 The illustrative notes to the financial statements include disclosures that are generally required, but are not intended to be all-inclusive and should be expanded, reduced, or modified to suit individual circumstances. Preparers and auditors of financial statements of credit unions should be familiar with the rules and regulations of the NCUA, or the appropriate state regulator, including those that relate to the form and content of financial statements.

A.3 The following assumptions apply to the illustrative financial statements:

- Sample Federal Credit Union is a federally chartered credit union.
- Sample Federal Credit Union owns 100 percent of Sample CUSO, a credit union service organization that provides insurance brokerage services to Sample Federal Credit Union's members.
- Sample CUSO has no taxable income and no income tax provision.
- The consolidated statements of cash flows have been prepared using the direct method.

Sample Federal Credit Union and Subsidiary
Consolidated Statements of Financial Condition
December 31, 19X2 and 19X1
(in thousands)

	19X2	19X1
Assets		
Cash and cash equivalents	$ XXX	$ XXX
Trading-account securities, at market value (note 2)	XXX	XXX
Investment securities (note 3)	X,XXX	X,XXX
Mortgage-backed securities (notes 3 and 4)	XXX	XXX
Loans held for sale, net of unrealized loss of $XXX in 19X2 and $XXX in 19X1 (note 11)	X,XXX	X,XXX
Loans receivable, net of allowance for loan losses (note 5)	XX,XXX	XX,XXX
Accrued interest receivable (note 6)	XXX	XX
Other real estate owned, net of allowance for losses (note 7)	XXX	XXX
Property and equipment (note 8)	X,XXX	XXX
NCUSIF deposit	XXX	XXX
Other assets	XX	XX
Total assets	$XX,XXX	$XX,XXX
Liabilities and Members' Equity		
Members' shares and savings accounts (note 9)	$XX,XXX	$XX,XXX
Borrowed funds (note 10)	X,XXX	X,XXX
Accrued interest payable	XXX	XXX
Accrued expenses and other liabilities	XXX	XXX
Total liabilities	XX,XXX	XX,XXX
Commitments and contingent liabilities (note 11)		
Members' equity, substantially restricted	X,XXX	X,XXX
Total liabilities and equity	$XX,XXX	$XX,XXX

See accompanying notes to consolidated financial statements.

Sample Federal Credit Union and Subsidiary
Consolidated Statements of Income
Years Ended December 31, 19X2 and 19X1
(in thousands)

	19X2	19X1
Interest income		
Loans receivable (note 5)	$X,XXX	$X,XXX
Investment securities	XXX	XXX
Total interest income	X,XXX	X,XXX
Interest expense		
Members' share and savings accounts (note 9)	X,XXX	X,XXX
Borrowed funds (note 10)	XXX	XXX
Total interest expense	X,XXX	X,XXX
Net interest income	X,XXX	X,XXX
Provision for loan losses (note 5)	XXX	XX
Net interest income after provision for loan losses	X,XXX	X,XXX
Non-interest income		
Gain (loss) on sale of interest-earning assets, net (note 12)	X,XXX	X,XXX
Unrealized gains (losses) on trading account securities, net	XXX	XXX
Commitment fees	XXX	XXX
Loan servicing fees (note 13)	XXX	XXX
Insurance commissions	XX	XX
Other (note 14)	XX	XX
Total non-interest income	X,XXX	X,XXX
Non-interest expense		
General and administrative		
Compensation and benefits (note 15)	XXX	XXX
Occupancy (note 11)	XXX	XXX
Other (note 14)	XXX	XXX
Total non-interest expense	X,XXX	XXX
Net income	$ XXX	$ XXX

See accompanying notes to consolidated financial statements.

Sample Federal Credit Union and Subsidiary
Consolidated Statements of Members' Equity
Years Ended December 31, 19X2 and 19X1
(in thousands)

	Regular Reserve	Undivided Earnings	Net Unrealized Depreciation on Certain Marketable Equity Securities	Total
Balance at December 31, 19X0	$X,XXX	$ XXX	$ XX	$X,XXX
Net income		XXX		XXX
Change in market value			XX	XX
Transfers	XXX	(XXX)		
Balance at December 31, 19X1	X,XXX	XXX	XX	X,XXX
Net income		XXX		XXX
Change in market value			XX	XX
Transfers	XXX	(XXX)		
Balance at December 31, 19X2	$X,XXX	$ XXX	$ XX	$X,XXX

See accompanying notes to consolidated financial statements.

Sample Federal Credit Union and Subsidiary
Consolidated Statements of Cash Flows
For the Years Ended December 31, 19X2 and 19X1
(in thousands)

	19X2	19X1
Cash flows from operating activities		
Interest received	$ X,XXX	$ X,XXX
Fees received	XXX	XXX
Proceeds from sales of trading securities	XXX	XXX
Purchase of trading securities	(XXX)	(XXX)
Insurance commissions received	XX	XX
Interest paid	(X,XXX)	(X,XXX)
Cash paid to employees and suppliers	(X,XXX)	(X,XXX)
Net cash provided by operating activities	X,XXX	X,XXX
Cash flows from investing activities		
Proceeds from maturities and sales of investment securities	X,XXX	X,XXX
Purchase of investment securities	(X,XXX)	(X,XXX)
Purchases of loans and mortgage-backed securities	(X,XXX)	(X,XXX)
Proceeds from sales of loans and mortgage-backed securities	X,XXX	X,XXX
Net decrease in consumer loans with original maturities of 3 months or less	XXX	XXX
Loan originations and principal collected on loans to members and mortgage-backed securities	(X,XXX)	(X,XXX)
Increase in NCUSIF deposit	(XXX)	(XXX)
Investment in other real estate owned	(XXX)	(XXX)
Proceeds from sales of other real estate owned	XXX	XXX
Proceeds from the sale of property and equipment	XX	–
Expenditures for property and equipment	(XXX)	(XXX)
Net cash used in investing activities	(X,XXX)	(X,XXX)
Cash flows from financing activities		
Net increase in members' share and savings accounts	X,XXX	X,XXX
New borrowings	X,XXX	X,XXX
Repayment of borrowed funds	(XXX)	(XXX)
Net cash provided by financing activities	X,XXX	X,XXX
Net increase in cash and cash equivalents	XXX	XX
Cash and cash equivalents at beginning of year	XXX	XXX
Cash and cash equivalents at end of year	$ XXX	$ XXX

Reconciliation of Net Income to Net Cash Provided by Operating Activities
(in thousands)

	19X2	19X1
Net income	$ XXX	$ XXX
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	XX	XX
Provision for loan losses	XXX	XX
Gain on sale of securities	(X,XXX)	(X,XXX)
Increase in trading securities	(XXX)	(XXX)
Loss on sale of property and equipment	XX	–
Increase in accrued interest receivable	(XXX)	(XXX)
Increase in accrued interest payable	XXX	XXX
Increase in accrued expenses and other liabilities	XXX	XXX
	$X,XXX	$X,XXX

See accompanying notes to consolidated financial statements.

Sample Federal Credit Union and Subsidiary
Notes to Consolidated Financial Statements
December 31, 19X2 and 19X1

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of consolidation. The consolidated financial statements include the accounts of Sample Federal Credit Union (the Credit Union) and its wholly owned subsidiary, Sample CUSO (the CUSO), a credit union service organization that provides insurance brokerage services to Credit Union members. All significant intercompany accounts and transactions have been eliminated.

Cash equivalents. Cash equivalents of $XXX and $XXX at December 31, 19X2 and 19X1, respectively, consist of federal funds sold, certificates of deposit, and funds due from banks. For purposes of the statements of cash flows, the Credit Union considers all highly liquid debt instruments with original maturities of three months or less to be cash equivalents.

Trading-account securities. Trading-account securities consisting of U.S. government bonds and mortgage-backed securities are carried at market value. Realized and unrealized gains and losses on trading-account securities are recognized in the statement of income as they occur.

Investment securities. Investment securities are stated at cost, adjusted for amortization of premiums and accretion of discounts computed using the interest method. Management intends to hold such investments to maturity. Cost of securities sold for purposes of computing gains or losses is determined by the specific identification method.

The noncurrent mutual fund of U.S. government and federal agency securities is accounted for as a marketable equity security and is stated at the lower of cost or market. Net unrealized losses are recognized through a valuation allowance that is shown as a reduction in the carrying value of the related securities and as a corresponding reduction in members' equity.

Loans held for sale. Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or estimated market value in the aggregate. Net unrealized losses are recognized in a valuation allowance by charges to income.

Mortgage-backed securities. Mortgage-backed and related securities are stated at cost, adjusted for amortization of premiums and accretion of fees and discounts computed by the interest method. It is generally management's intention to hold such assets to maturity. Should any be sold, cost of securities for purposes of computing gains and losses is determined by the specific identification method. All sales are made without recourse.

Loans receivable and allowance for loan losses. Loans receivable are stated at unpaid principal balances, less an allowance for loan losses and net deferred loan origination fees and discounts. Interest on loans is recognized over the term of the loan and is calculated using the simple-interest method on principal amounts outstanding.

Discounts on first mortgage loans are amortized to income using the interest method over the remaining period to contractual maturity, adjusted for anticipated prepayments. Discounts on consumer loans are recognized over the lives of the loans using methods that approximate the interest method.

Loan fees and certain direct loan-origination costs are deferred, and the net fee or cost is recognized as an adjustment to interest income using the interest method over the contractual life

of the loans, adjusted for estimated prepayments adjusted to the Credit Union's historical prepayment experience. Commitment fees and costs relating to commitments whose likelihood of exercise is remote are recognized over the commitment period on a straight-line basis. If the commitment is subsequently exercised during the commitment period, the remaining unamortized commitment fee at the time of exercise is recognized over the life of the loan as an adjustment of yield.

The allowance for loan losses is increased by charges to income and decreased by chargeoffs (net of recoveries). Management's periodic evaluation of the adequacy of the allowance is based on the Credit Union's past loan-loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and current economic conditions.

Accrual of interest on a loan is discontinued when management believes, after considering economics, business conditions, and collection efforts, that the borrowers' financial condition is such that collection of interest is doubtful. Uncollectible interest previously accrued is charged off or an allowance is established by means of a charge to interest income. Income is subsequently recognized only to the extent cash payments are received until, in management's judgment, the borrower's ability to make periodic interest and principal payments is back to normal, in which case the loan is returned to accrual status.

NCUSIF deposit. The deposit in the National Credit Union Share Insurance Fund (NCUSIF) is in accordance with NCUA regulations, which require the maintenance of a deposit by each insured credit union in an amount equal to 1 percent of its insured shares. The deposit would be refunded to the Credit Union if its insurance coverage is terminated, it converts to insurance coverage from another source, or the operations of the fund are transferred from the NCUA Board.

NCUSIF insurance premiums. A credit union is required to pay an annual insurance premium equal to one-twelfth of 1 percent of its total insured shares, unless the payment is waived or reduced by the NCUA Board. The NCUA Board waived the 19X2 and 19X1 insurance premium.

Other real estate owned. Real estate properties acquired through or in lieu of loan foreclosure are initially recorded at fair value at the date of foreclosure. Costs relating to development and improvement of property are capitalized, whereas costs relating to holding property are expensed. The portion of interest costs relating to development of real estate is capitalized.

Valuations are periodically performed by management, and an allowance for losses is established by means of a charge to operations if the carrying value of a property exceeds its estimated net realizable value.

Property and equipment. Land is carried at cost. Building, leasehold improvements, and furniture, fixtures, and equipment are carried at cost, less accumulated depreciation and amortization. Buildings and furniture, fixtures, and equipment are depreciated using the straight-line method over the estimated useful lives of the assets. The cost of leasehold improvements is amortized using the straight-line method over the terms of the related leases.

NCUSIF deposit. The deposit in the NCUSIF is in accordance with NCUA regulations, which require the maintenance of a deposit by each insured credit union in an amount equal to 1 percent of its insured shares.

Members' share and savings accounts. Interest rates are set by the board of directors, based on an evaluation of current and future market conditions.

Members' equity. The 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 interest.

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

Income taxes. The Credit Union is exempt, by statute, from federal and state income taxes. The CUSO, however, is subject to federal and state income taxes. Operations of CUSO resulted in no income taxes for the years ended 19X2 and 19X1.

Pension-plan. The Credit Union has a qualified, noncontributory defined-benefit pension plan covering substantially all of its employees. The Credit Union's policy is to fund the minimum amount required under ERISA.

NOTE 2 – TRADING-ACCOUNT SECURITIES

The estimated market values of trading-account securities are as follows (in thousands):

	December 31,	
	19X2	19X1
U.S. government bonds	$ XXX	$ XXX
FHLMC Certificates	XXX	XXX
	$ XXX	$ XXX

NOTE 3 – INVESTMENT SECURITIES

The carrying value and estimated market value of investment securities are as follows (in thousands):

	Weighted Average Yield at December 31, 19X2	December 31,			
		19X2		19X1	
		Carrying Value	Estimated Market Value	Carrying Value	Estimated Market Value
U.S. government and federal agency securities	X.XX%	$X,XXX	$X,XXX	$X,XXX	$X,XXX
Mutual fund of U.S. government and federal agency securities	X.XX%	XXX	XXX	XXX	XXX
	X.XX%	$X,XXX	$X,XXX	$X,XXX	$X,XXX

The amortized cost and estimated market values of investments in debt securities, including mortgage-backed securities, at December 31, 19X2, are as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
U.S. government and federal agency securities	$X,XXX	$ XXX	$ (XX)	$X,XXX
Mortgage-backed securities	XXX	X	(X)	XXX
	$X,XXX	$ XXX	$ (XX)	$X,XXX

The amortized cost and estimated market value of debt securities, including mortgage-backed securities, at December 31, 19X2, 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.

	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
	$X,XXX	$X,XXX

Proceeds from sales of investments in debt securities, including mortgage-backed securities, during 19X2 were $XXX. Gross gains of $XX and gross losses of $XX were realized on those sales.

At December 31, 19X2 and 19X1, securities carried at approximately $XXX and $XXX, respectively, were pledged as collateral to secure borrowed funds.

NOTE 4 – MORTGAGE-BACKED SECURITIES

The carrying values and estimated market values of mortgage-backed securities are summarized as follows (in thousands):

	December 31, 19X2				
	Principal Balance	Unamortized Premiums	Unearned Discounts	Carrying Value	Estimated Market Value
GNMA certificates	$XXX	$ XX	$(XX)	$XXX	$XXX
FHLMC certificates	XXX	–	(XX)	XXX	XXX
	$XXX	$ XX	$(XX)	$XXX	$XXX

	December 31, 19X2				
	Principal Balance	Unamortized Premiums	Unearned Discounts	Carrying Value	Estimated Market Value
GNMA	$XXX	$ (XX)	$ XX	$XXX	$XXX
FHLMC	XXX	–	(XX)	XXX	XXX
	$XXX	$ XX	$ (XX)	$XXX	$XXX

NOTE 5 – LOANS RECEIVABLE

The composition of loans to members is as follows (in thousands):

	December 31,	
	19X2	19X1
Automobile	$XX,XXX	$XX,XXX
Mortgage	X,XXX	X,XXX
Unsecured	X,XXX	X,XXX
Business	X,XXX	X,XXX
Lines of credit	X,XXX	X,XXX
Share-secured loans	X,XXX	X,XXX
Education	X,XXX	X,XXX
Credit card loans	X,XXX	X,XXX
Other	X,XXX	X,XXX
Net deferred loan origination fees	(XXX)	(XXX)
	XX,XXX	XX,XXX
Less		
Allowance for loan losses	XXX	XXX
	$XX,XXX	$XX,XXX

A summary of the activity in the allowance for loan losses is as follows (in thousands):

	Year Ended December 31,	
	19X2	19X1
Balance, beginning of year	$XXX	$ XX
Provision charged to operations	XXX	XX
Loans charged off	(XX)	(XX)
Recoveries	XX	XX
Balance, end of year	$XXX	$XXX

Loans on which the accrual of interest has been discontinued or reduced amounted to $XXX and $XXX at December 31, 19X2 and 19X1, respectively. If interest on those loans had been accrued, such income would have approximated $XX and $X for 19X2 and 19X1, respectively. Interest income on those loans, which is recorded only when received, amounted to $X and $X for 19X2 and 19X1, respectively.

Included in loans receivable at December 31, 19X2, are loans of $X,XXX to directors and officers of the Credit Union and its subsidiary. Such loans are made in the ordinary course of business at normal credit terms, including interest rates and collateralization.

NOTE 6 – ACCRUED INTEREST RECEIVABLE

Accrued interest receivable is summarized as follows (in thousands):

	December 31,	
	19X2	19X1
Investment securities	$ XX	$ XX
Mortgage-backed securities	X	–
Loans receivable	XXX	XXX
Other	X	X
	$XXX	$XXX

NOTE 7 – OTHER REAL ESTATE OWNED

Activity in the allowance for losses on other real estate owned is as follows (in thousands):

	December 31,	
	19X2	19X1
Balance, beginning of year	$ XX	$ XX
Provision charged to operations	X	X
Chargeoffs, net of recoveries	(X)	(X)
Balance, end of year	$ XX	$ XX

NOTE 8 – PROPERTY AND EQUIPMENT

Property and equipment is summarized as follows (in thousands):

	December 31, 19X2	December 31, 19X1
Land	$ XXX	$ XXX
Building	XXX	XXX
Furniture and fixtures	XXX	XXX
Office equipment	XXX	XXX
Leasehold improvements	XXX	XXX
	X,XXX	X,XXX
Accumulated depreciation and amortization	(XXX)	(XXX)
	$X,XXX	$X,XXX

NOTE 9 – MEMBERS' SHARES AND SAVINGS ACCOUNTS

Members' share and savings accounts are summarized as follows (in thousands):

	Weighted-Average Rate At December 31, 19X2	December 31, 19X2 Amount	December 31, 19X1 Amount
Share draft accounts including non-interest-bearing deposits of $X,XXX in 19X2 and $X,XXX in 19X1	X.XX%	$ X,XXX	$ X,XXX
Money market	X.XX%	XX,XXX	XX,XXX
Share savings	X.XX%	X,XXX	X,XXX
		XX,XXX	XX,XXX
Share certificate accounts and IRAs:			
X % to X %	X.XX	-	XX,XXX
X % to X %	X.XX	XX,XXX	XX,XXX
X % to X %	X.XX	X,XXX	X,XXX
X % to X %	X.XX	XXX	XXX
		XX,XXX	XX,XXX
	X.XX%	$XX,XXX	$XX,XXX

The aggregate amounts of members' share and savings accounts over $100,000 were approximately $XX,XXX and $XX,XXX at December 31, 19X2 and 19X1.

At December 31, 19X2, scheduled maturities of share certificates are as follows (in thousands):

	Year Ending December 31,					
	19X3	19X4	19X5	19X6	19X7	Thereafter
X % to X %	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
X % to X %	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
X % to X %	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
X % to X %	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX

Interest expense on members' share and savings accounts is summarized as follows (in thousands):

	December 31,	
	19X2	19X1
Money market	$X,XXX	$X,XXX
Share savings	X,XXX	X,XXX
Share draft	X,XXX	X,XXX
Certificates	X,XXX	X,XXX
	$X,XXX	$X,XXX

NOTE 10 – BORROWED FUNDS

Borrowed funds are as follows (in thousands):

	December 31,	
	19X2	19X1
Corporate Credit Union, variable rate (XX% at December 31, 19X2), due 19X3, secured	$X,XXX	$ ––
Note payable to bank, interest at bank prime rate (X.X% at December 31, 19X2), payable in quarterly interest and annual principal installments through December 31, 19X9, unsecured	X,XXX	X,XXX
Certificates of indebtedness, interest at X.X% to X.X%, various due dates	XXX	XXX
	$X,XXX	$X,XXX

Scheduled maturities of long-term debt outstanding at December 31, 19X2, are as follows (in thousands):

Years Ending December 31,	Amount
19X3	$X,XXX
19X4	XXX
19X5	XXX
19X6	XXX
19X7	XXX
Thereafter	X,XXX
	$X,XXX

The Credit Union is a member of the NCUA Central Liquidity Facility (Facility), which was formed to assist member credit unions in meeting their short-term liquidity needs. Membership is obtained through investment in shares of the Facility as determined by a statutory formula. As of December 31, 19X2, the Credit Union had not borrowed from this Facility.

NOTE 11 — COMMITMENTS AND CONTINGENT LIABILITIES

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 the Credit Union.

The principal commitments of the Credit Union are as follows:

Lease Commitments

At December 31, 19X2, the Credit Union was obligated under noncancelable operating leases for office space. Certain leases contain escalation clauses providing for increased rentals based primarily on increases in real estate taxes or in the average consumer price index. Net rent expense under operating leases, included in occupancy and equipment expenses, was approximately $XXX and $XXX for the years ended December 31, 19X2 and 19X1, respectively.

The projected minimum rental payments under the terms of the leases at December 31, 19X2, net of sublease rentals, are as follows (in thousands):

Years Ending December 31,	Amount
19X3	$ XXX
19X4	XXX
19X5	XXX
19X6	XXX
19X7	XXX
19X8 and thereafter	X,XXX
	$X,XXX

Loan Commitments

At December 31, 19X2, the Credit Union had outstanding commitments for unused lines of credit and to originate or purchase loans that are not reflected in the accompanying consolidated financial statements as follows (in thousands):

	Fixed-rate	Variable-rate	Total
First mortgage loans	$X,XXX	$X,XXX	$X,XXX
Consumer and other loans	X,XXX	X,XXX	X,XXX
Lines of credit	X,XXX	X,XXX	X,XXX
Credit cards	XXX	XXX	XXX
	$X,XXX	$X,XXX	$X,XXX

At December 31, 19X2, the Credit Union had no outstanding commitments to sell loans or securities.

Financial Instruments With Off-Balance-Sheet Risk

The Credit Union is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its members and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit and put options on loans held for sale. Those instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amount recognized in the statement of financial position. The contract or notional amounts of those instruments reflect the extent of involvement the Credit Union has in particular classes of financial instruments.

The Credit Union's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual notional amount of those instruments. The Credit Union uses the same credit policies in making commitments as it does for on-balance-sheet instruments. For put options, the contract or notional amounts do not represent exposure to credit loss.

Unless noted otherwise, the Credit Union does not require collateral or other security to support financial instruments with credit risk.

	Contract or Notional Amount (in thousands)
Financial instruments whose contract amounts represent credit risk	
Commitments to extend credit	$X,XXX
Financial instruments whose notional or contract amounts exceed the amount of credit risk	
Put options on loans held for sale	XX
	$X,XXX

Commitments to extend credit are agreements to lend to a member as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Credit Union evaluates each member's creditworthiness on a case-by-case basis. The amount of collateral obtained if deemed necessary by the Credit Union upon extension of credit is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties.

Interest-rate options are contracts that allow the holder of the option to purchase or sell a financial instrument at a specified price and within a specified period of time from the seller or "writer" of the option. The Credit Union, in accordance with NCUA regulations, holds only long positions on put options for FHLMC certificates. Because it is an option contract, the maximum potential cost is known at the outset.

Financial Instruments With Concentrations of Credit Risk

Most of the Credit Union's business activity is with its members who are employees or former employees of ABC Corporation (the Corporation). Loans totaling $XX,XXX are outstanding to the Corporation's employees and former employees at December 31, 19X2. The Credit Union's policy for requiring collateral is *[state policy, along with information about the entity's access to that collateral or other security and a description of collateral].*

NOTE 12 — GAIN ON SALES OF INTEREST-EARNING ASSETS

Net gains are summarized as follows (in thousands):

	December 31,	
	19X2	19X1
Realized gain on sales of		
Mortgage-backed securities	$ X,XXX	$ X,XXX
Investment securities	X,XXX	X,XXX
First mortgage loans	X,XXX	X,XXX
	$ X,XXX	$ X,XXX

NOTE 13 — LOAN SERVICING

Mortgage loans serviced for others are not included in the accompanying consolidated statements of financial condition. The unpaid principal balances of these loans are summarized as follows:

	December 31,	
	19X2	19X1
Mortgage loan portfolios serviced for		
FNMA	$XX,XXX	$XX,XXX
Other investors	XX,XXX	XX,XXX
	$XX,XXX	$XX,XXX

Custodial escrow balances maintained in connection with the foregoing loan servicing were approximately $X,XXX and $X,XXX at December 31, 19X2 and 19X1, respectively.

The Credit Union recognized amortization on excess servicing fees receivable of $X and $X for the years ended 19X2 and 19X1, respectively, which is reflected in loan-servicing fees in the consolidated statements of income.

NOTE 14 – OTHER NON-INTEREST INCOME AND EXPENSE

Other non-interest income and expense amounts are summarized as follows (in thousands):

	December 31,	
	19X2	19X1
Other non-interest income:		
Service charges and fees	$ XX	$ XX
Loan late charges	XX	XX
Other	XX	XX
	XX	XX
Other non-interest expense:		
Advertising and promotion	$XXX	$XXX
Data processing	XXX	XXX
Professional fees	XXX	XXX
Printing, postage, stationery, and supplies	XXX	XXX
Telephone	XXX	XXX
Unrealized loss on valuation of loans held for sale	XXX	XXX
Other	XXX	XXX
	$XXX	$XXX

NOTE 15 – PENSION PLAN

The Credit Union has a qualified, noncontributory defined-benefit pension plan covering substantially all of its employees. The benefits are based on each employee's years of service up to a maximum of XX years, and the average of the highest five consecutive annual salaries of the ten years prior to retirement. The benefits are reduced by a specified percentage of the employee's social security benefit. An employee becomes fully vested upon completion of XX years of qualifying service.

The following table sets forth the plan's funded status and amounts recognized in the Credit Union's statements of financial condition (in thousands):

	December 31,	
	19X2	19X1
Actuarial present value of benefit obligations		
Accumulated benefit obligation		
Vested	$XX,XXX	$XX,XXX
Nonvested	XX,XXX	XX,XXX
	XX,XXX	XX,XXX
Projected benefit obligation for service rendered to date	XX,XXX	XX,XXX
Plan assets at fair value; primarily listed stock, cash, and short-term investments	XX,XXX	XX,XXX
Plan assets in excess of projected benefit obligation	XX,XXX	XX,XXX
Unrecognized net gain from past experience different from that assumed and effects of changes in assumptions	(X,XXX)	(X,XXX)
Prior service cost not yet recognized in periodic pension cost	X,XXX	X,XXX
Unrecognized net transition asset (from adoption of FASB Statement No. 87) being amortized over XX years	(X,XXX)	(X,XXX)
Prepaid pension cost (included in other assets)	$ X,XXX	$ X,XXX

The components of net pension expense are as follows (in thousands):

	December 31,	
	19X2	19X1
Service cost — benefits earned during the period	$ X,XXX	$ X,XXX
Interest cost on projected benefit obligation	X,XXX	X,XXX
Actual return on plan assets	(X,XXX)	(X,XXX)
Net amortization and deferral	X,XXX	X,XXX
Net pension expense	$ X,XXX	$ X,XXX
Assumptions used to develop the net periodic pension cost were		
Discount rate	X%	X%
Expected long-term rate of return on assets	X%	X%
Rate of increase in compensation levels	X%	X%

SUGGESTED GUIDELINES FOR CPA PARTICIPATION IN CREDIT UNION SUPERVISORY COMMITTEE AUDITS

This appendix has been prepared by the Credit Unions Committee for the information of AICPA members and other interested parties. However, it does not represent an official position of any of the Institute's senior technical committees.

THE NATURE OF SUPERVISORY COMMITTEE AUDITS

B.1 Section 701.12 of the NCUA *Rules and Regulations* and many state regulations governing state-chartered credit unions require periodic examinations of credit unions by the supervisory committee. The term *supervisory committee audit* is derived from these requirements. In fulfilling its responsibilities, the supervisory committee may personally complete the audit procedures or may engage other parties, including internal auditors or CPAs, to assist them. Thus, the supervisory committee may assign the authority to perform some or all audit procedures to other parties, but ultimate responsibility for an audit that fulfills the requirements of the regulatory agency rests with the supervisory committee.

B.2 Credit union regulatory agencies often require the supervisory committee to report on the results of its audit. Some regulatory agencies also specify the form and content of such reports. Usually, the supervisory committee audit report is presented in one of the following formats:

- A report prepared in compliance with regulatory agency or statutory requirements and on prescribed forms
- A report containing the supervisory committee's comments on the scope and results of the audit, and also referring to the report of a CPA or other third party who performed some of the audit procedures on the supervisory committee's behalf
- A statement by the supervisory committee referring to the report of a CPA or other third party who performed all of the audit procedures on the supervisory committee's behalf in accordance with the requirements of the regulatory agency

B.3 The AICPA Credit Unions Committee (Committee) believes that guidance is necessary for CPAs wishing to assist credit union supervisory committees in performing supervisory committee audits. Specifically, the Committee believes assistance is necessary to enable CPAs to provide supervisory committees with services that meet both the objectives of the supervisory committee's audit and the standards of the accounting profession.

Scope of Services Rendered by CPAs

B.4 The scope of services rendered by CPAs in connection with supervisory committee audits varies, depending on the circumstances of the engagement, the needs of the supervisory committee, and the requirements of the regulatory agency. However, the types of services requested of CPAs generally fall into the following categories:

- The CPA may be engaged to audit the credit union's financial statements. The purpose of an audit of a credit union's financial statements in accordance with generally accepted

auditing standards is to enable the CPA to express an opinion on the financial statements. An audit of financial statements is usually acceptable in fulfilling supervisory committee audit requirements established by regulatory agencies that have specific minimum audit requirements. Many regulatory agencies' supervisory committee audit requirements can be met by an audit of only the statement of financial condition. Accordingly, the supervisory committee may request an audit either as the sole basis for fulfilling supervisory committee audit requirements or as a supplement to the performance of other supervisory committee audit procedures. In either event, the supervisory committee is ultimately responsible for an audit that meets the requirements of regulatory agencies, and some regulatory agencies may require a separate report or statement from the supervisory committee indicating its conclusions, even though the audit was based solely on the CPA's report.

- A CPA may be engaged by the supervisory committee to perform specified audit procedures. These procedures are generally designed to meet the regulatory agency's requirements. The CPA's special report describing the nature and results of procedures performed is usually submitted to the supervisory committee without financial statements. However, certain states require that the report submitted to the agency include certain unaudited financial statements or data.

The Committee believes that, while both types of services may meet the regulatory agency requirements for a supervisory committee audit, an audit of financial statements in accordance with GAAS generally provides the greatest benefit to a credit union's management, supervisory committee, and members. As noted earlier, an audit in accordance with GAAS generally meets the supervisory committee audit requirements of federal and state regulatory agencies.

B.5 In some instances, the scope of the independent auditor's services may not be clear when the auditor is engaged to conduct a supervisory committee audit. Contributing reasons for this lack of understanding include the following:

- The majority of supervisory committee audits are performed for credit unions whose supervisory committee members and officers may have a limited knowledge of the differences between an audit in accordance with GAAS and a supervisory committee audit.

- Generally, supervisory committee audit reports do not incorporate the financial statements of the credit union.

- Although the NCUA and certain states specify minimum scope requirements for supervisory committee audits, the requirements of other states are undefined.

- The procedures agreed upon by the supervisory committee and independent auditors may provide for limited procedures related to the testing of loans and the evaluation of the reasonableness of the allowance for loan losses that has been determined by management (for example, reviewing the adequacy of loan documentation but not the collectibility of loans).

B.6 The scope of an independent auditor's services regarding a supervisory committee audit, especially as it relates to areas of higher risk, is also subject to misinterpretation by others, including regulatory authorities. This is of particular concern because regulators increasingly rely on the results of supervisory committee audits or audits of the credit union's financial statements in accordance with GAAS to determine the frequency and scope of their examinations.

GUIDANCE FOR PROCEDURES AGREED UPON WITH THE SUPERVISORY COMMITTEE

B.7 AICPA members performing audits in accordance with GAAS are guided by the AICPA's Statements on Auditing Standards. These auditing standards are designed for engagements resulting in a CPA's opinion on financial statements; also, they are generally applicable to other types of engagements, such as services performed by a CPA in connection with supervisory committee audits. Guidance is limited, however, regarding the procedures to be applied by a CPA when he is engaged by the supervisory committee to perform only certain agreed-upon procedures. Thus, CPAs should be aware, when discussing the proposed scope of the engagement or describing procedures frequently followed in similar types of engagements, that the procedures to be applied may be affected by the specific regulatory agency's requirements.

B.8 SAS No. 35 should serve as the principal guidance for CPAs engaged to apply agreed-upon procedures in connection with supervisory committee audits. A CPA's participation in a supervisory committee audit should be structured to meet the individual needs of the credit union and its supervisory committee and the requirements, if applicable, of the regulatory agency. The CPA and the supervisory committee should have a clear understanding of the scope of the CPA's procedures and the specific responsibilities of each party. In this regard, SAS No. 35, paragraph 1, states:

> An accountant may accept an engagement in which the scope is limited to applying, to one or more specified elements, accounts, or items of a financial statement, agreed-upon procedures that are not sufficient to enable him to express an opinion on the specified elements, accounts, or items, provided (*a*) the parties involved have a clear understanding of the procedures to be performed and (*b*) distribution of the report is to be restricted to named parties involved.

Paragraph 3 of SAS No. 35 states that the general standards are applicable to these types of engagements; thus, in accordance with the second general standard, the accountant must be independent.

B.9 The CPA may be requested to assist the supervisory committee in determining the procedures to be performed by the supervisory committee or by other third parties. In this regard, the CPA may be asked to meet with the regulatory agencies to ascertain their specific requirements.[28] As a result, changes may need to be made in the scope of either the entire supervisory committee examination or the CPA's engagement.

B.10 The CPA should consider issuing an engagement letter describing the agreement with the supervisory committee on scope and responsibility. The letter would state that the purpose of the CPA's engagement is to assist the supervisory committee in performing the supervisory committee audit and that responsibility for completing the applicable regulatory agency's supervisory committee audit requirements, if any, and for reporting the results to the agency rests with the supervisory committee. The engagement letter may include, among other things, details of the

[28] SAS No. 35, paragraph 2, states that the parties involved *[should]* have a clear understanding of the procedures to be performed. For circumstances in which the CPA is unable to discuss the procedures directly with all of the parties who will receive the report, paragraph 2 gives examples of procedures the CPA may take, such as comparing the procedures to be applied to written requirements of a regulatory agency or distributing a draft of the report or a copy of the client's engagement letter to the parties involved with a request for their comments before the report is issued.

major areas to be covered, the extent of procedures to be performed in each area, and any specific regulatory agency requirements to be omitted. An illustrative engagement letter appears at the end of this appendix.

B.11 Reporting guidance and an illustrative special report for agreed-upon procedures in connection with a supervisory committee audit are presented in chapter 15.

Illustrative Engagement Letter
Services Other Than Financial Statement Audits

Supervisory Committee
XYZ Credit Union

[Date]

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide to XYZ Credit Union for the year ending *[date]*.

We will apply certain procedures to selected records and transactions for the purpose of helping you to complete your supervisory committee audit.

The procedures to be performed are summarized in the supplement to this letter. Because those procedures will not constitute an audit made in accordance with generally accepted auditing standards, we will not express an opinion on any of the items specified in the supplement or on the financial statements of the credit union taken as a whole. The scope of this audit as outlined in the supplement does not include an evaluation of all areas that generally are of higher risk in the credit union industry, such as securities held or the collectibility of loans, the adequacy of collateral thereon, or the reasonableness of the allowance for loan losses.

Our engagement will not include a detailed examination of all transactions and cannot be relied on to disclose errors, irregularities, or illegal acts, including fraud or defalcations, that may exist. However, we will inform you of any such matters that come to our attention.

We direct your attention to the fact that management has the responsibility for the proper recording of the transactions in the accounting records and for preparation of financial statements in conformity with generally accepted accounting principles.

Certain of the procedures described in the supplement to this letter will be applied on a surprise basis during the year after we consult with the appropriate regulatory agencies to ensure that the date selected will not conflict with their examinations.[29]

Our report will include a summary of the accounts and elements subject to our audit and the procedures performed.[30]

This report will be issued solely for the information of the credit union's supervisory committee and management and appropriate regulatory agencies [*or other specified third parties*]; it is not to be used by any other parties because of the restricted nature of our work. Our report will also contain a paragraph indicating that had we performed

[29] Some supervisory committee audits may not be conducted on a surprise basis or include consultation with regulatory agencies.

[30] In certain instances, the independent auditor may not be able to discuss the procedures to be performed with all the parties — for example, bonding companies — that will receive a copy of the report. In these circumstances, the auditor should satisfy the requirements of paragraph 2 in SAS No. 35 by applying alternate procedures in order that the parties involved be made aware of the procedures applied before the report is issued.

additional procedures or had we made an audit of the financial statements in accordance with generally accepted auditing standards, other matters might have come to our attention that would have been reported to you.

Our fees are based on the time required by the individuals assigned to the engagement, plus direct expenses. Individual hourly rates vary according to the degree of responsibility involved and the skill required. Interim billings will be submitted as services are rendered and as expenses are incurred.

We will be pleased to discuss this letter with you at any time. If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Sincerely yours,

____

[Signature of Independent Auditor]

Acknowledged:

____

[Name of Credit Union]

____

[Signature of Credit Union Director][31, 32]

[Date]

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[31] Preferably, the chairman of the supervisory committee or an outside director should acknowledge the procedures to be performed.

[32] The independent auditor should consider reviewing the engagement letter with the supervisory committee in order to allow its participation in defining the scope of the audit.

Supplement to Illustrative Engagement Letter
Procedures to Be Performed in
Connection With a Supervisory Committee Audit

In connection with our engagement, the procedures to be performed are summarized as follows:

1. General

   a. Start the engagement on a date selected by us without prior notification of credit union personnel, officers, or directors. Obtain immediate control *[seal vault, etc.]* of assets and records and maintain control until applicable procedures have been completed. The surprise procedures will cover the main office and *[the following]* branches.

   b. Review reports of examination by, and correspondence with, regulatory agencies.[33]

   c. Review minutes of meetings of the board of directors and of committees reporting to the board.

   d. Review entries to selected general ledger accounts in excess of $____________.

   e. Review accounting procedures for handling nonledger assets, such as loan chargeoffs and recoveries, loan commitments, loans "participated" to and serviced for others, collection items, travelers' checks, and U.S. savings bonds.

   f. Obtain letters concerning litigation, claims, and assessments from legal counsel.

   g. Obtain management representation letters.

Procedures to be performed with respect to individual accounts or elements should be listed in detail, including number and types of confirmations, extent of tests and revenue and expense, and types of sampling methods to be used. Individual accounts and elements to which other procedures are applied generally include:

1. Cash, cash items, and clearings and exchanges

2. Securities

3. Federal funds sold *[purchased]*

4. Loans and leases

5. Real estate owned

Note: This Supplement is for illustrative purposes only and, therefore, is not considered to be an all-inclusive list of accounts that may be examined and procedures that may be performed. The illustrative procedures listed may or may not be relevant to a particular engagement. The independent auditor should describe those accounts examined and procedures relevant to the specific engagement.

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[33] Independent auditors should refer to the policies of regulatory agencies on the use of supervisory information.

GLOSSARY

allowance for loan losses. A contra asset account established and maintained by periodic charges to operating expenses to provide a balance for absorbing possible future loan losses in a credit union's loan portfolio.

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

asset-liability management. A financial management concept in which both asset and liability decisions are determined jointly; generally, management attempts to match the interest and maturity profiles of assets and liabilities in order to minimize interest rate and liquidity risk.

batch. A grouping of similar items (for example, deposits or incoming checks) assembled for proofing purposes. Such a grouping is also referred to as a "block".

call report (5300 report). A required periodic report on a credit union's financial condition that is submitted to a credit union supervisory agency.

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 borrowing funds.

certificate of indebtedness. An uninsured time deposit that generally bears interest at rates higher than those paid on savings accounts. The certificates may be offered to nonmembers as well as to members. See **promissory notes.**

chattel. Personal property such as automobiles, furniture, appliances, and other movable property.

club account. A savings plan whereby a depositor makes periodic (usually weekly) payments.

collateral. Specific property that a borrower pledges as security for the repayment of a loan. The borrower agrees that the lender will have the right to sell the collateral for the purpose of liquidating the debt if the borrower fails to repay the loan as promised or otherwise defaults under the terms of the loan agreement.

co-maker loan. A loan made by more than one debtor (generally unsecured; a second debtor may be required because of the poor or unknown credit standing of the first debtor).

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

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

corporate credit union. A credit union organized by credit unions to offer central deposit and lending facilities 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 bureau. An organization that accumulates and makes credit information available to its members.

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 association designed to provide a forum for credit union executives to exchange ideas and disseminate information.

Credit Union National Association, Inc. (CUNA). A national non-profit dues-supported trade association serving credit unions and credit union leagues in the United States.

CUNA Mutual Insurance Group. An organization formed in 1935 to serve the insurance needs of credit unions and their members and to provide them with a variety of related programs and services.

Credit Union Service Corporations (CUSOs). Subsidiaries of credit unions that are authorized to perform related functions, such as those typically performed by an insurance or escrow agency, as well as data processing and conveyancing.

daylight overdraft. An overdraft on the Federal Reserve that is settled on the same day.

deficiency judgment. A legal claim against a debtor for the balance of debt remaining after repossession and sale of the collateral, plus allowable expenses.

dividend. The amount paid to a member as a rate of return for savings in a credit union. In the aggregate, this is an expense, classified as interest expense, for financial statement presentation.

dormant account. A savings account in which there has been no member activity for a specified period of time.

escheat. The reversion of property, such as the property of a decedent with no heirs and unclaimed or abandoned property, to the state.

escrow. The delivery of a deed to a third person who will release the deed to the grantee upon fulfillment of certain specified conditions. Escrow is also commonly used to designate accounts to which the periodic deposits by borrowers are credited for the payment by credit union of real estate taxes and insurance premiums when they become due.

fair value. As used in this proposed guide, the amount that a debtor could reasonably expect to receive for assets in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale.

Federal Financial Institutions Examination Council (FFIEC). A council composed of representatives from the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision, and the National Credit Union Administration that prescribes uniform principles and standards for the federal examination of financial institutions and makes recommendations to promote uniformity in the supervision of the financial institutions.

federal funds. Loans to another financial institution (or loans from another financial institution) that increase (or decrease) the other institution's reserve account with a Federal Reserve bank. The loans are generally repayable the following day and are commonly referred to as *federal funds purchased* by the borrowing institution or *federal funds sold* by the investing institution. The loans may be secured by U.S. government or federal agency securities.

Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac). 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.

Federal National Mortgage Association (FNMA or Fannie Mae). A corporation that provides a secondary market for residential housing mortgages.

Federal Reserve Board (FRB). A board of seven members appointed by the President and confirmed by the Senate, 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.

fidelity bond. Insurance against losses arising from errors and dishonest acts of employees and involving money, merchandise, or other property; persons or positions may be covered by fidelity bonds.

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.

garnishment. The attachment of salaries through court action to collect on a defaulted obligation.

Government National Mortgage Association (GNMA or Ginnie Mae). 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.

home equity loan. A first or second mortgage loan that allows the borrower to use the portion of equity in his or her residence to increase borrowing capacity.

junior mortgage. A mortgage, for example, a second mortgage, subordinate to prior or other mortgages.

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.

line of credit. An arrangement under which a lender provides a specified maximum amount over a stated period that may be used at a borrower's discretion.

loan fee. The amount charged by the mortgagee for granting a loan, often referred to as *points*, *acquisition credits*, or *initial service charge*. Loan fees are generally stated as a percent of the face amount of the loan. The charge is generally made to cover the cost of placing the loan on the books, but may also represent, in part, an adjustment of yield.

loan participation. A purchased interest in a loan originated by another lender. Loan participations may be negotiated on a recourse or a nonrecourse basis, on terms the same as or different from the original loan terms.

mortgage-backed securities. Securities including bonds collateralized by mortgage loans issued by the FNMA and FHLMC, and pass-through certificates.

mortgage participation certificate. A certificate representing an undivided interest in specified conventional residential mortgages underwritten and owned by the FHLMC. The FHLMC unconditionally guarantees the payment of principal and interest.

mortgage servicing. An arrangement whereby the servicing credit union, for a specified fee, maintains all records related to the loans serviced, assumes the responsibility for billing and collecting periodic payments, and distributes principal and escrow amounts as required.

National Association of Federal Credit Unions (NAFCU). A national non-profit, dues-supported trade association servicing federal credit unions in the United States.

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

National Credit Union Administration (NCUA). An independent agency of the federal government for chartering, insuring, supervising, and examining federal credit unions and for administering the Central Liquidity Facility and the National Credit Union Share Insurance Fund. In addition, NCUA insures state chartered credit unions that desire and qualify for federal insurance.

National Credit Union Share Insurance Fund (NCUSIF). The fund established by Congress in 1970 to insure members' share accounts up to $100,000 at federally insured credit unions. In return for this protection, each insured credit union is required to deposit and maintain 1 percent of its insured shares in the fund, and may be required to pay premiums.

pass-through certificate. A certificate guaranteed by the 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 the GNMA.

promissory note. A note issued in evidence of an agreement with a lender. 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.

regular reserve. An appropriation of undivided earnings established in accordance with the Federal Credit Union Act and/or the NCUA Rules and Regulations or state statutes to provide for the financial stability of the credit union.

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

retained earnings. Generally, the earnings reported in the equity section of a credit union's statement of financial condition; retained earnings includes undivided earnings, statutory reserves, and other appropriations as designated by management or regulatory authorities.

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

risk assets. Risk assets are defined in various state statutes and in section 700.1(j) of the *National Credit Union Administration Rules and Regulations* by listing those assets that are to be excluded from the calculations of risk assets. Examples of some of the items that may be excluded from risk assets are loans fully secured by shares, FHA insured loans, insured student loans, and investments in the Central Liquidity Facility.

share certificate. A time-deposit certificate issued in evidence of an agreement between the financial institution and a member. A penalty may be required for early withdrawal of funds. Dividends are paid on a share certificate.

secondary mortgage market. A market in which transactions, primarily those 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 draft. A payment mechanism, similar to a check, that enables credit union members to withdraw funds or pay obligations from their credit union share account.

signature card. A card bearing a member's signature that 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 undivided earnings that includes the regular reserve or a reserve required by state statute.

Student Loan Marketing Association (Sallie Mae). An organization created by an act of Congress to provide a secondary market for buying, selling, and servicing student loans.

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

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