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WE HAVE BEEN WITNESSING a gradual but certain trend from the reliance of regulated businesses solely upon examination of financial statements by government examiners to independent examinations conducted by certified public accountants. Certainly, a major reason for this trend is the rapid growth of our economy coupled with the inability of the agencies to maintain staffs adequate to cope with this growth. Just as railroads, banks, insurance companies, and other members of regulated industries are turning to certified public accountants for managerial advice as well as for the conduct of independent examinations, credit unions are seeking our help.

To appreciate the growth of credit unions, we must recall that the first credit union in the United States was not organized until 1909. Today there are 20,000 credit unions. Their total assets aggregate \$4 billion. The average growth rate in the number of credit unions has been about 6%, while assets have been growing at an annual rate of 20%. Membership runs in excess of ten million, with an annual average growth rate of 10%. It is estimated that six out of every one hundred persons in the United States belong to a credit union. Although statistics for Canada are proportionately about one-fourth of

INDEPENDENT EXAMINATION OF CREDIT UNIONS

by **Walter H. Bando**

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ours, 13% of the population are members. In the face of this rapid growth, it is understandable that governmental agencies charged with supervising the activities of credit unions have been forced more and more to restrict the scope of their examinations.

Credit unions are corporations chartered and regulated by the state banking departments or by the Bureau of Federal Credit Unions (a section of United States Department of Health, Education, and Welfare). About half of the credit unions have a federal charter. A common confusion — even among the informed — is to associate credit unions with labor unions. It is true that some locals of labor unions have organized credit unions, but they have been formed within the more fundamental credit union principle which states that thrift can be best taught and encouraged among a group of people who have a strong common bond—be it occupational, industrial, governmental, fraternal, religious, residential, or otherwise. Through combined savings the members, as shareholders, are able to extend low-cost credit to fellow shareholders when they need it.

Credit unions have been classified by economists as a form of consumers' cooperative. As such certain financial institutions, mainly

short-term, high-interest finance companies, have contended that credit unions are a form of unfair competition, since they enjoy exemption from federal taxes on income. Actually this is not true, since credit unions are nonprofit organizations which pay out their earnings by annual or semi-annual dividends to all their member shareholders in proportion to the time their savings were invested in shares. Interest (limited to 6% per annum) is credited on the basis of full share dollars held during each month. To the borrower, whose interest rate is limited to 1% a month on the unpaid balance by both federal and state Acts, rebates are paid either on the basis of "as-you-go" anticipation discounts for prompt monthly payments or by a lump sum annual refund. Such policies have resulted in a minimum interest rate for borrowing and a maximum return on investment in shares. Many banks have recognized these advantages and encouraged formation of credit unions for their own employees.

In the field of personal finance, membership in a well-run credit union puts the individual shareholder and his family immediately at an advantage: For instance, a 25-cent membership fee and one fully paid-in share for \$5 makes one eligible in most credit unions for an unsecured \$750 loan payable in five years and for collateral loans limited in amount and time only by the bylaws. Some credit unions protect loans and share savings, either or both, by group life insurance so that an estate is created for a shareholder in the event of his passing, and any debt to the credit union is cancelled. These advantages, however, are considered to be "fringe" benefits of membership; the basic objective of a credit union is to encourage individuals to develop personal budgets that work through regular savings habits.

Staffs of lawyers reassigned

So successful have been the efforts of the credit committees who have worked on the personal financial problems of their fellow members that managements of business, both small and large, have encouraged the formation of credit unions in their own stores and plants. There are no specific direct credits to earnings statements, but the "know-how" gained by their employees is such that entire staffs of lawyers handling employees' garnishments have been reassigned to more productive endeavors after the introduction of a credit union. Unstable workers who have been forced to adopt deficit-financing

from unscrupulous high-carrying-charge merchandisers and related high premiums for short-term life insurance have been able to straighten out their budgets through credit union help without recourse to payroll advances or loans from their employers. In this country there are more than 30,000 members of credit committees who serve without pay, rendering advice and extending loans to solve personal financial problems.

Because of the peace of mind that credit unions bring to their members, furniture and fixtures as well as office space are often donated by corporations, churches, governmental agencies, and other sponsors as their contribution toward organization of a credit union. When self-sufficient, credit unions usually move into their own offices.

II.

Because credit unions are legal entities chartered under state or Federal law, accountants preparing to make examinations of credit unions will be interested in how they are regulated by public bodies and how they are managed. The Federal Credit Union Act was enacted on June 26, 1934, and is contained in Chapter 14 of Title 12 of the United States Code. The first state credit union law was passed in 1909 in Massachusetts, largely as a result of the efforts of Alphonse Desjardins and Edward A. Filene. The latter, a wealthy Boston merchant and founder of the store that bears his name, spent a personal fortune of a million dollars to launch the credit union movement. Today, all but four states (Delaware, Nevada, Wyoming, and South Dakota) have their own credit union laws.

The organizational set-up of a credit union is laid down in state and federal acts by prescribing model by-laws to be followed by the credit union incorporators. Such models are available in published pamphlet form from the regulatory bodies. Section 9 of the Federal Act provides that "in order to simplify the organization of federal credit unions, the Director shall from time to time cause to be prepared a form of organization certificate and a form of bylaws, consistent with this Act, which shall be used by credit union incorporators, and shall be supplied to them on request. At the time of presenting the organization certificate the incorporators shall also submit proposed bylaws of the Director for his approval." The Michigan Act contains a similar provision.

Section 6 of the Federal Act provides that each federal credit union shall be "under supervision of the Director, and shall make such

reports (at least annually) as he may require, and shall be subject to examination by, and for this purpose shall make its books and records accessible to, any person designated by the Director." Presumably, then, a federal credit union could be examined by a certified public accountant approved by the Director.

The state credit union acts tend to be somewhat more specific in this area. For instance, Section 6 of the Michigan Credit Union Act provides that "Credit unions shall be examined at least annually by the said commissioner (of the state banking department) except that he may accept the audit of a certified public accountant in place of such examination."

Law provides for a supervision fee

Both the state and federal acts provide for a supervision fee. Michigan uses a diminishing rate starting at seven cents per \$100 or fraction thereof on the first \$1,000,000 of total assets of a credit union and going to one cent per \$100 or fraction thereof on all the assets in excess of \$10,000,000; or \$6.00 per examiner-hour, whichever is lower. The minimum examination fee is \$25.00 in Michigan.

The Federal Act provides for a supervision fee and an examination fee. The supervision fee ranges from a minimum of \$10 and goes into a graduated scale starting at 30 cents per \$1,000 for total assets of \$500,000 or less and works up to a maximum rate of \$925, plus 10 cents per \$1,000 for total assets of \$5 million or more. The federal fee for the annual examination is computed in accordance with a scale of fees established by the Director, "giving due consideration to the time and expense incident to such examinations, and to the ability of federal credit unions to pay such fees."

The Michigan statute has two additional features not found in the federal: The initial examination fee for a credit union upon issuance of a charter is limited to \$10; and a penalty of \$5 a day is exacted from a credit union for each day of delinquency on its annual report, due on or before December 31 on blanks supplied by the Commissioner.

Both the state and federal acts uniformly provide that the fiscal year of all credit unions shall end December 31. The federal act specifically states that "the annual meeting of each Federal credit

union shall be held at such time during the month of the following January and at such place as its bylaws may prescribe." Both time and place for the annual meeting of the shareholders are selected in "the manner indicated in the bylaws," according to Michigan law.

The business affairs of a credit union are managed by a board of directors of not less than five members. They also elect a credit committee of not less than three members and, in state credit unions, a supervisory committee of three members. In federal credit unions a supervisory committee of three members, one of whom may be a director other than the treasurer, is appointed by the board. The directors at their first meeting elect from their own number a president, vice-president, treasurer, and secretary. The latter two positions may be held by the same person. Officers and directors meet monthly and hold additional meetings if necessary.

The treasurer is the active manager of the credit union. He maintains the books, prepares financial reports, and is in charge of receiving and disbursing funds. Members come to him with their financial problems and he routes their loan applications to the credit committee. Most of the work falls upon him so he may be paid for his work, although other board and committee members serve without pay.

Watchdog over the credit union operations is the supervisory or examining committee. Its functions, as outlined in the federal and most state acts, can be summarized as follows:

1. Make at least quarterly internal audits, reporting directly to their memberships and the state or federal regulatory bodies.
2. Make at least biennial verifications of all members' accounts and pass books with the records of the Treasurer.
3. Suspend any officer, member, or committeeman for any violation of the act, by-laws, or charter or any practice deemed to be unsafe or unauthorized; and to fill vacancies until successors have been elected at the next annual meeting.

This committee has been provided with such "do-it-yourself" aids as accounting manuals, handbooks, copies of the federal and state acts, and work sheet forms to facilitate their work. There is a suggested

program of examination for the committee to follow in the "Supervisory Committee Manual for Federal Credit Unions," including a questionnaire form of review of internal control and accounting procedures and an outline of audit procedures covering the fact-finding phase.

Any expense of the supervisory committee, including the selection of independent accountants, must be approved by the board of directors. In effect the officers, including the treasurer, as members of the board could turn down the request of the supervisory committee for an examination by independent accountants. As in other regulated industries which already pay annual fees for the federal or state examinations, there is a reluctance to duplicate fees.

Actually, however, there need not be any duplication. As pointed out in a preceding paragraph, the credit union, by proper application to its supervising state or federal agency, can request that the audit of a certified public accountant be accepted in place of the governmental examination.

Another solution is to suggest joint examinations with the government examiners. Such arrangements have worked out satisfactorily for bank examinations, but the use of outside help precludes the rendering of an unqualified opinion in our accountants' reports. The surprise nature of the examination can be preserved by prearrangement with the government agencies.

Responsibility . . . is a matter of law

Whatever the solution may be, it must be emphasized that the function and responsibility of a supervisory or examining committee is a matter of law and cannot be transferred to a professional accountant. The federal bureau's manual stresses the point that the financial statements are the credit union's and that the certified public accountant is only rendering his opinion on them.

There is only one specific audit procedure mentioned in the acts: verification of members' accounts. The importance placed on this auditing step may well be a decision-making factor for the supervisory committees in seeking professional help, for this is one large area in which the independent accountant can perform more efficiently than the committee members because of his training and familiarity

with confirmation procedure. For smaller credit unions, perhaps a piecemeal report on the independent verification of loan and share balances may provide the assurance required to satisfy the regulatory agencies as well as the shareholders.

The acts, both federal and state, require that members of the board of directors and committees limit their own borrowings to the amounts of their share balances. In 1959, the federal law was amended to allow the shareholdings of any other credit union member to be pledged as security for an officer's loan.

The original intent of the legislators was undoubtedly to keep their judgment objective and uninfluenced by personal interest. In a "do-it-yourself" setup, this seems to make sense at first glance; but why should those who have contributed most to the success of an organization be penalized? The contradictory nature of this limitation has been recognized by the Michigan Credit Union League which has been actively proposing as a part of its legislative platform that the state act be amended to allow credit union officers to participate in the privileges of membership like any other shareholder. Would it appear that the case of the League would be strengthened if it could be added that independence of judgment on the fairness of the credit union financial statements is assured by their examination by certified public accountants?

As a safeguard to the shareholders, legal reserves are required by both state and federal Acts. All entrance fees and fines provided by the bylaws for failure to make repayments on loans and payments on shares when due and 20% of the net earnings of each year before the declaration of dividends must be set aside as a statutory reserve against losses on bad loans and other losses. Additional reserves may be required by regulation or by the Director in federal credit unions. When the legal reserve reaches 10% of the assets, no transfer of net earnings to such account is required except to maintain the 10% relationship. While our duty to review the adequacy of the statutory reserve is clear, our review of the basis (such as aging of the loans receivable) for special reserves required by regulation is equally important.

III

Because the share accounts of the members are not insured under any government plans similar to federal deposit insurance for banks

and savings associations, the natural question arises: what is being done to safeguard savings?

In addition to the activities of the Supervisory or Examining Committee and the increasing use of certified public accountants, credit unions are usually members of a state credit union league. Credit union leagues are nonprofit, voluntary associations of credit unions, supported by the dues of member credit unions. For example, some 1,100 credit unions in Michigan voluntarily pay dues (based upon a percentage on net earnings after interest refunds on loans) as members of the Michigan Credit Union League. Fifteen per cent of the dues is allocated to "stabilization services" for the purpose of aiding distressed member credit unions with noninterest-bearing loans and outright grants of funds and purchasing the notes for outstanding loans from credit unions in liquidation. The League's officers state that no credit union shareholder in Michigan has lost a penny of his savings because the League's stabilization services has furnished the funds to pay the shareholders 100 cents on the dollar on share accounts, taking in exchange the unpaid notes receivable of the credit union. Since 1955 the League has acquired almost \$400,000 of such notes at a cost of about \$330,000. Of this sum, some \$150,000 of principal amount has been collected, while \$60,000 has been written off as uncollectible. In 1959 alone, \$80,000 was disbursed to purchase the notes of liquidating credit unions. In order to minimize these costs, the League is exploring in two directions:

- a. Direct transfer of shareholder loans and share balances of liquidating credit unions to other credit unions, with a guarantee by the League to make good to the transferee credit union any unusual losses sustained. This creates a contingent liability for the League but avoids the necessity for an immediate cash outlay.
- b. A statement of policy by the League that membership in the League does not in itself guarantee, in the case of liquidation, automatic purchase of a credit union's outstanding notes receivable. If a credit union has not followed, for example, a clearly established system of internal control and accounting procedures, the League reserves the right to refuse aid from its stabilization services. Self-insurance protection by the League to the shareholders of its member credit unions can be withheld if it is the opinion of the trustees of the stabilization services that liquidation was reasonably avoidable.

Since the adequacy of the system of internal control and account-

ing procedures is within the scope of an independent accountant's examination, it appears that far-sighted Boards of Directors and Supervisory Committees should take the precaution of obtaining opinions of independent accountants so as not to jeopardize their eligibility for aid from their own League. This appears especially desirable for credit unions organized in private corporations. It is true that some company credit unions have expanded their common bond to the community when a corporation goes out of business or decides to move. An example is the Daisy Employees Federal Credit Union in Plymouth, Michigan, which became the Plymouth Community Credit Union. But for each Daisy there are a dozen forced liquidations which cannot continue by expanding their membership cores. In fairness to members, both as employees and shareholders, management and credit union officials should be encouraged to retain the services of certified public accountants so that their internal control and accounting procedures are kept in good order and notes receivable (which in a typical credit union represent about 75% or more of its total assets) are readily negotiable either to the League or to another credit union. Stabilization services is a new idea and is rapidly being adopted by credit union leagues of other states.

In addition to the protection afforded by stabilization services of the state leagues, surety bonds are available to cover employees of a credit union. Coverage up to \$2 million of the assets of a credit union is now available from the bonding service of the Credit Union National Association (CUNA).

IV

Although the calendar year is the fiscal year for all credit unions, in all but the smallest credit unions records are maintained on a daily self-balancing basis so that surprise examinations may be planned for any business day in the year. Since the growth of credit unions has been rapid, it is quite possible that some of the larger organizations may still be using monthly summaries and manual postings. So it is important to predetermine what dates are available for audit.

Even though, as a member of the board of directors, the treasurer will be aware of an authorization to have an examination by independent accountants, it is of utmost importance to keep the actual date of the examination a secret known only to the Supervisory Committee. A study made by the Bureau of Federal Credit Unions on defalcations (89 cases in a two-year period) reveals that the treas-

urer was responsible for 64% of them. This again is not surprising when one considers that he alone may have access to all the records as well as negotiables. Where dual control over the latter has not been introduced, preserving the element of surprise may be the difference between a successful and an unsuccessful examination.

To ensure a successful examination, a detailed program of examination which recognizes the strong as well as the weak points in the internal control and accounting procedures is necessary. Such a program should be developed by discussion with members of the supervisory committee in advance of the audit. A review of the working papers and reports of the examiners as well as the Committee could help reveal in advance patterns likely to be encountered in our examination.

What happens on the first day

As in a bank or a brokerage examination, the most exacting day is the first day of field work. On that day, it will be necessary for the audit team to maintain complete control over the funds and records of the credit union and subsequently release funds and records back to the client only after necessary information has been obtained. All cash and negotiables must be counted simultaneously and compared to the records. Members' loan and share ledger balances must be run and their totals compared to the control balances shown by the general ledger. Such a controlled situation also assumes that all postings of transactions are completed as of the date of examination. Where tellers handle cash and also post member ledgers, reconciling amounts between the tape run and the controls require our independent review for possible fictitious transactions. Prompt dispatch of verification requests to members on the first day is necessary so that the records can be turned back to the credit union on the next business day. Examination of the loan file for collateral as well as the original notes and related approval of loans, including adequacy of insurance (automobile, fire, life, and nonrecording title), should begin on the first day and the loan file be kept under seal until work is completed.

The accounting basis for credit unions can be cash, modified cash, or accrual. Because the credit unions have not been exposed to professional advice of independent accountants (this comment applies also to banks and saving and loan associations) it is to be expected that many will be found that are on a cash basis. Adjustments to

the accrual basis and standard recurring journal entries necessary to put the accounting on such a basis will make the financial statements and ratios useful tools for management for future budgeting as well as detection of significant trends. To help management get on top of the figures so that statements are meaningful in steering their course in long-range planning may be the most useful contribution an independent examination can give a credit union. Consistency of basis from year to year can, of course, be obtained only by accrual accounting.

Since credit unions are exempt from all taxation on income, the general policy is to distribute all earnings in the form of dividends to shareholders and interest refunds to borrowers (who are shareholders at year-end). The legal limitation on dividends is 6%, and the Board of Directors must ascertain before the year ends what policy it is to follow. Where loans are lagging to a low percentage of total assets, it may be necessary to hike interest refunds to encourage use of credit union loan facilities. On the other hand, close watch must be maintained to see what the going rate of interest is being paid on savings accounts by banks and savings and loan associations. The decisions reached in this area will be recorded in the Minutes of the Board and the independent accountant must determine that they are being carried out with proper credits to shares accounts. In this connection, it bears repetition to ascertain that all liabilities were recognized on an accrual basis before the board of directors established their current dividend and interest refund policy. The failure to recognize commitments for a new building or some other major expansion program, for instance, could result in a financial crisis.

Projections into the future

Another area which the independent accountant cannot ignore is the degree of dependence the credit union has on a source for its shareholders. The risk inherent in company credit unions, religious credit unions in changing neighborhoods, declining occupations such as milk delivery groups, and other situations must be recognized by the accountant. Possible mergers with other credit unions before operations begin to decline or a broadening of the common bond to a wider coverage such as the community—these are decisions in which the independent accountant may be asked to help by preparation of

preliminary pro forma statements and projections into the future for feasibility studies.

The independent examination of financial statements, then, may be just the beginning of the professional services we can render to credit unions. Management sciences and management services are imperative if the credit unions are to continue their growth. In a budget installation, for instance, the forecast of deposits in shares based on a projection of a pattern of past deposits, the correlation of general business conditions and the resultant vulnerability to withdrawals, the availability of funds for loans and the investment of idle funds—all these present a challenge for professional consultation to credit union management. Forward-looking officers of state leagues have been organizing seminars in management with discussions on such subjects as the desirability of the use of logistics strategy and operation research in planning as well as the place of the marketing role in credit unions.

To merit the confidence of the credit unions as clients, we must convince credit union management of the need for independent examinations to establish the basis for future planning. Not all credit unions can afford the services of independent accountants, but generally speaking, certainly all credit unions with assets over \$1 million can afford annual independent examinations. And it may be that those who think they cannot afford our services, the smaller credit unions, may be the very ones who need independent consultation most. Planned profits have been successfully utilized in industry and there is no reason why a nonprofit organization cannot apply the same lessons learned to its operations.



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