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Audit and Accounting Guide

AUDITS of CREDIT UNIONS

As of December 1, 1992

AICPA
American Institute of Certified Public Accountants

Audit and Accounting Guide

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As of December 1, 1992

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American Institute of Certified Public Accountants

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NOTICE TO READERS

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

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The Credit Unions Committee 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.

Preface

This audit and accounting guide supersedes the AICPA Audit and Accounting Guide *Audits of Credit Unions*, which was originally issued in 1986, and subsequent editions of that guide with conforming changes made by the AICPA staff. The principal objective of this guide is to help independent auditors audit and report on the financial statements of natural-person credit unions. The guide is not intended to apply to corporate credit unions; however, portions of the guide may be useful to auditors of corporate credit unions. This guide has been written to be one of the principal reference sources that auditors consult in auditing credit unions' financial statements. In addition, it is intended to help the supervisory committees, managements, and directors of credit unions, as well as other interested persons, understand the nature and scope of audits of credit unions by independent auditors. The guide also contains suggested guidelines for CPA participation in supervisory committee audits (see appendix B).

This 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 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 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*
3. SOP 92-3, *Accounting for Foreclosed Assets*

The 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 guide also incorporates the provisions of AICPA Practice Bulletin No. 7, *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed,* as amended by AICPA Practice Bulletin No. 10, *Amendment to Practice Bulletin 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 all authoritative auditing and accounting pronouncements, including those issued after the issuance of the 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 sources of established accounting principles that 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 Professional Conduct.

Finally, users of this guide should also be aware that certain accounting and auditing issues affecting credit unions are currently under study by the AICPA Credit Unions Committee, the AICPA Accounting Standards Executive Committee, and the FASB. These issues include recognition and measurement issues associated with financial instruments and accounting for foreclosed assets.

Effective Date and Transition

The accounting and financial reporting provisions of this 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 guide shall be applied prospectively to financial statements of credit unions for fiscal years beginning on or after December 15, 1992.

Industry Background

Introduction

Credit unions are member-owned, not-for-profit cooperative financial institutions that allow those in specific fields of membership to pool their savings, borrow funds, 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 exempt from federal income taxes.

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 earning returns for owners, are the primary reason for their existence.

Organization and Structure

The first credit union in the United States was organized in 1909. Although 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 initiatives that have affected 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 or 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. The members direct the formation of credit union policies and practices by electing a board of directors to represent them.

Financial Structure

Because they are nonstock cooperatives, credit unions' primary source of funds is members' share and savings account deposits. To be entitled to membership, each member must generally 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 interest (often referred to as dividends) on shares. This interest cannot be guaranteed (as interest on deposits can), but must be declared by the board and may be paid from current or undivided earnings. For regulatory purposes, the NCUA requires that members' shares be classified as equity. *Generally accepted accounting principles require that members' 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. In general, 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 member services and 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 have 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.

TABLE OF CONTENTS

Chapter		Paragraph
1	Organization and Supervision	.01-.19
	Organization and Structure	.01-.06
	The Board of Directors	.02
	The Supervisory Committee	.03-.05
	The Credit Committee	.06
	Charter, Bylaws, and Minutes	.07
	Government Supervision	.08-.10
	National Credit Union Administration	.11-.14
	Enforcement Issues	.12-.14
	Regulatory Accounting Practices	.15-.16
	Annual Audits	.17-.19
2	Auditing Planning and General Considerations	.01-.44
	Introduction	.01-.02
	Scope of Services	.01
	Audit Planning	.02
	Knowledge of the Industry	.03-.04
	Risks in the Credit Union Industry	.05-.10
	Credit Risk	.06-.07
	Interest Rate Risk	.08
	Liquidity Risk	.09
	Risk Management	.10
	Knowledge of the Client's Business	.11-.14
	Internal Control Structure	.15-.20
	Data Processing Provided by Independent Organizations	.21
	Analytical Procedures	.22-.24
	Consideration of the Possibility of Material Misstatements	.25-.26
	Communications Between Independent Auditors and Regulators	.27-.31
	Compliance With Regulations	.32-.36
	Client Representations	.37
	Going Concern Considerations	.38-.44
3	Cash	.01-.14
	Introduction	.01-.05
	Financial Statement Presentation	.06
	Audit Objectives and Procedures	.07-.14
	Audit Objectives	.07
	Planning Considerations	.08

Chapter | Paragraph

3 Cash—continued
Internal Control Structure .09-.10
Tests of Controls .11-.13
Substantive Tests .14
4 Investment Securities .01-.62
Introduction .01-.02
Investment Activities .03-.16
Corporate Credit Union Network .06
Debt Securities .07
Mortgage-Backed Securities .08
Mortgage-Related Derivatives .09-.11
Mutual Funds .12
Repurchase Agreements .13-.14
Hedging Instruments .15-.16
Accounting Principles: Measurement and Disclosure .17-.50
Premiums and Discounts .17-.18
Carrying Value of Investments and Financial Statement Presentation .19-.49
Off-Balance-Sheet Risks .50
Audit Objectives and Procedures .51-.62
Audit Objectives .51
Planning Considerations .52-.54
Internal Control Structure .55
Tests of Controls .56
Substantive Tests .57-.62
5 Loans .01-.81
Introduction .01-.15
Types of Loans .05-.15
Accounting Principles: Measurement and Disclosure .16-.53
Loan Participation, Sales, Purchases, and Servicing .18-.22
Troubled-Debt Restructurings .23
In-Substance Foreclosures .24-.35
Allowance for Loan Losses .36
Interest Income .37-.38
Loan Fees and Costs .39-.44
Financial Statement Presentation .45-.53
Audit Objectives and Procedures .54-.81
Audit Objectives .54

Chapter		Paragraph
5	Loans—continued	
	Internal Control Structure	.55-.56
	Tests of Controls	.57
	Substantive Tests	.58-.80
	Regulatory Restrictions	.81
6	Allowance for Loan Losses	.01-.60
	Introduction	.01-.10
	Methods for Estimating Allowances for Loan Losses	.04-.10
	Accounting Principles: Measurement and Disclosure	.11-.19
	Financial Statement Presentation	.18-.19
	Audit Objectives and Procedures	.20-.60
	Audit Objectives	.20
	Planning Considerations	.21-.23
	Internal Control Structure	.24-.34
	Tests of Controls	.35-.36
	Evaluating the Adequacy of the Allowance for Loan Losses	.37-.57
	Regulatory Compliance	.58-.60
7	Mortgage-Banking Activities	.01-.31
	Introduction	.01-.04
	Loan Servicing	.05-.07
	Accounting Principles: Measurement and Disclosure	.08-.24
	Loans Held for Sale	.08-.09
	Sales of Loans	.10-.13
	Sales of Loans With Recourse	.14
	Servicing Rights	.15-.16
	Purchased Servicing Rights	.17-.18
	Sales of Servicing Rights	.19-.21
	DVA No-Bids and Private Mortgage Agencies	.22-.23
	Financial Statement Presentation	.24
	Audit Objectives and Procedures	.25-.31
	Audit Objectives	.25
	Planning Considerations	.26-.27
	Internal Control Structure	.28-.29
	Tests of Controls	.30
	Substantive Tests	.31

Chapter		Paragraph
8	Members' Share and Savings Accounts	.01-.18
	Introduction	.01-.03
	Accounting Principles: Measurement and Disclosure	.04-.06
	Financial Statement Presentation	.05-.06
	Audit Objectives and Procedures	.07-.18
	Audit Objectives	.07
	Internal Control Structure	.08-.09
	Tests of Controls	.10
	Substantive Tests	.11-.18
9	Borrowed Funds and Other Obligations	.01-.23
	Introduction	.01-.08
	Certificates of Indebtedness	.03
	Mortgages Payable	.04
	Capital Lease Obligations	.05
	Federal Funds Purchased	.06
	Letters of Credit	.07
	Reverse-Repurchase Agreements	.08
	Accounting Principles: Measurement and Disclosure	.09-.14
	Audit Objectives and Procedures	.15-.23
	Audit Objectives	.15
	Planning Considerations	.16
	Internal Control Structure	.17
	Tests of Controls	.18
	Substantive Tests	.19-.23
10	Other Assets and Other Liabilities	.01-.41
	Introduction	.01-.02
	Accounting Principles: Measurement and Disclosure	.03-.29
	Other Assets	.03-.24
	Other Liabilities	.25-.29
	Audit Objectives and Procedures	.30-.41
	Audit Objectives	.30-.31
	Planning Considerations	.32-.33
	Internal Control Structure	.34-.35
	Substantive Tests	.36-.41
11	Equity	.01-.13
	Introduction	.01
	Accounting Principles: Measurement and Disclosure	.02-.09
	Undivided Earnings	.02

Chapter		Paragraph
11	Equity—continued	
	Regular Reserve (Statutory Reserve)	.03-.06
	Appropriated Undivided Earnings	.07-.08
	Financial Statement Presentation	.09
	Audit Objectives and Procedures	.10-.13
	Audit Objectives	.10
	Auditing Procedures	.11-.13
12	Computer Processing	.01-.08
	Introduction	.01-.04
	Audit Objectives and Procedures	.05-.08
	Audit Objectives	.05
	Internal Control Structure	.06-.07
	Reference Materials	.08
13	Business Combinations	.01-.17
	Introduction	.01
	Accounting Principles: Measurement and Disclosure	.02-.11
	NCUSIF-Assisted Acquisition of Credit Unions	.07-.11
	Audit Objectives and Procedures	.12-.17
	Audit Objectives	.12
	Internal Control Structure	.13
	Substantive Tests	.14-.17
14	Statement of Cash Flows	.01-.10
	Introduction	.01
	Operating Cash Flows	.02-.04
	Investing and Financing Cash Flows	.05-.07
	Noncash Investing and Financing Activities	.08
	Definition of *Cash and Cash Equivalents*	.09-.10
15	Reporting Considerations	.01-.13
	Introduction	.01
	Reports on Audited Financial Statements	.02-.05
	Standard Independent Auditor's Report	.02
	Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)	.03-.04
	Members' Shares Reported as Equity	.05
	Reports on Supervisory Committee Audits	.06-.11
	Communication of Internal Control Structure Related Matters	.12-.13

Appendix

A Illustrative Credit Union Financial Statements

B Suggested Guidelines for CPA Participation in Credit Union Supervisory Committee Audits

Glossary

Chapter 1

Organization and Supervision

Organization and Structure

1.01 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

1.02 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

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

1.04 Supervisory committees play an important role in developing and maintaining strong operational and financial management at credit unions. As credit unions continue to broaden the nature and scope of the activities in which they are involved, it is important that supervisory committees meet regularly and carefully review operational and financial goals, internal control structure policies and procedures, financial statements, and examiners' and auditors' reports. Lack of supervisory committee involvement in credit union operations may be an early indicator of potential problems for credit unions.

1.05 Statement on Auditing Standards (SAS) No. 61, *Communication With Audit Committees,* establishes the requirement that auditors determine that certain matters related to the conduct of an audit are communicated to those who have responsibility for oversight of the financial reporting process.

In the credit union environment, it is generally the supervisory committee that has that responsibility and to which such matters are communicated.

The Credit Committee

1.06 The credit committee establishes and monitors a credit union's lending 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

1.07 The NCUA issues charters for federally chartered credit unions and prescribes the form of bylaws of such credit unions. State regulatory authorities establish the form of the charter and bylaws for state-chartered credit unions. The regulatory authorities generally require monthly meetings of the board of directors and other volunteer committees.

Government Supervision

1.08 Credit unions operate under either a federal or state charter and therefore are subject to government supervision and regulation, including periodic examinations by supervisory agency examiners. Federally chartered credit unions are 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.

1.09 State-chartered credit unions are 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.

1.10 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, and the Internal Revenue Service. Rules and regulations issued by the federal and state regulatory agencies address such issues as accounting practices, qualifications for membership, interest rate controls, permissible investments, consumer-protection issues, liquidity reserves, and other operational aspects.

National Credit Union Administration

1.11 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. Federally insured, state-chartered credit unions sign an insurance agreement with the NCUA when they secure federal insurance that stipulates the regulations by which 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.

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. FIRREA also included a provision that defines auditors as institution-affiliated parties and subjects the independent auditors of credit unions to potential financial and criminal liability. NCUA regulations include a similar provision. In addition, 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 use a letter of understanding and agreement (LUA) or similar contractual arrangement to formalize the negotiated agreement between the regulatory agency or agencies (the regional director represents the NCUA) and the credit union's board of directors concerning problems, the actions to be taken, and the timetable for completing each action. In dealing with a state-chartered, non-NCUSIF-insured credit union, the state regulator will usually involve the appropriate state or private insurer.

Regulatory Accounting Practices

1.15 Accounting practices prescribed by federal and state regulatory agencies, commonly referred to as regulatory accounting practices (RAP), frequently 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 the independent auditor of a credit union is engaged to report on financial statements prepared in accordance with RAP he or she should consider the guidance in SAS No. 62, *Special Reports*. Chapter 15 includes

further discussion of auditors' reports on financial statements prepared in conformity with a basis of accounting other than generally accepted accounting principles.

Annual Audits

1.17 A credit union may engage an independent auditor to perform an independent audit in accordance with generally accepted auditing standards (GAAS) or a supervisory committee audit (an agreed-upon-procedures engagement; see appendix B). Credit unions are also generally subject to examinations by regulatory agencies.

1.18 As used in this 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 of federally chartered credit unions are prescribed by section 701.12 of the NCUA *Rules and Regulations.* State-chartered credit unions are subject to the audit requirements established by state regulatory agencies. 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 procedures that are necessary to fulfill the federal or state requirements. 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 an engagement to perform a supervisory committee audit.

Chapter 2

Auditing Planning and General Considerations

Introduction

Scope of Services

2.01 The scope of the services rendered by auditors generally depends on the types of reports to be issued as the result of the engagement. Early in the audit, the auditor should establish an understanding with credit union management regarding the services to be performed and the reports to be issued. Following are some of the services that auditors are typically engaged to perform for credit unions:

- Auditing the financial statements in accordance with generally accepted auditing standards
- Applying agreed-upon procedures 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)

Audit Planning

2.02 The first standard of fieldwork states: "The work is to be adequately planned and assistants, if any, are to be properly supervised." SAS No. 22, *Planning and Supervision,* provides guidance on the considerations and procedures applicable to planning and supervision in an audit conducted in accordance with generally accepted auditing standards. Audit planning involves developing an overall strategy for the conduct and scope of the audit. SAS No. 22 recognizes that the nature, timing, and extent of planning will vary with the size and complexity of the entity whose financial statements are being audited, as well as with the auditor's experience with the entity and knowledge of the entity's business. As required by SAS No. 22, the auditor should possess sufficient knowledge of matters affecting credit unions, including applicable regulations.

Knowledge of the Industry

2.03 Generally accepted auditing standards require the auditor to obtain an understanding of the industry in which the client operates. Such an understanding is essential to the performance of an audit with due professional care.

2.04 To adequately plan an audit of the financial statements of a credit union, the auditor should be familiar with the characteristics of the operations and business of credit unions that are unique to the industry and require the auditor's consideration in assessing audit risk, developing an overall audit strategy, and performing auditing procedures. Some of those characteristics include—

- *The regulatory environment.* The regulation of the credit union industry is discussed in chapter 1. The effects of regulatory trends can have a significant effect on the operations of credit unions.

While deregulation of products and services affords credit unions new ways of attracting members, deregulation of rates paid on insured deposits may create downward pressure on earnings. Auditors of credit unions should understand the regulatory environment in which credit unions operate, including the rules and policies of the NCUA and other applicable regulatory agencies.

- *Financial products and instruments.* In recent years a number of new complex and highly sophisticated investment vehicles have been developed and made available to credit unions and other financial institutions. Such investment vehicles include repurchase agreements, mortgage-backed securities, and mortgage derivatives. The auditing and accounting implications of such investments can be significant, and they should be carefully considered by auditors.
- *The internal control environment.* The assets of credit unions generally are highly negotiable and liquid. As a result, they may be subject to greater risk of loss than are the assets of other businesses. In addition, the operations of credit unions are characterized by a high volume of transactions. As a result, the effectiveness of internal control structure policies and procedures is a significant audit consideration.
- *The economic environment.* The lending policies of credit unions must take into consideration the economic environment to minimize the risk of credit losses. A deterioration in the national or local economy or a downturn in a particular industry may expose credit unions to increased risk of loss if lending policies are too lenient or fail to prevent too many loans of a single type or concentrations of loans in single geographic areas.

Risks in the Credit Union Industry

2.05 To determine the scope of audit procedures to be performed, the auditor should be aware of the risks that are inherent in the operations of financial institutions in general and the credit union industry in particular. For example, credit unions face three major types of risk with respect to the investing and lending activities that encompass the major part of their operations: credit risk, interest rate risk, and liquidity risk.

Credit Risk

2.06 Credit risk refers to the probability that a borrower may not repay a loan. Credit risk is a significant concern for credit unions. Decisions to grant loans are based on information about a borrower's ability and willingness to repay a loan at the time a loan is made. Thus, credit risk can be controlled to some extent by the establishment of sound lending policies and procedures. However, since economic and other factors may vary over the life of a loan, a borrower's ability and willingness to repay the loan may change as well. As a result, credit risk fluctuates over time.

2.07 In planning an audit of a credit union, the auditor should be alert to factors that may indicate increased levels of credit risk. Such factors include—

- Weak or undocumented lending policies and procedures.
- Unfavorable trends in general economic conditions.
- The declining financial condition of the credit union's sponsoring organization or field of membership.

- Significant loan concentrations.

Interest Rate Risk

2.08 Credit unions also face exposure to interest rate risk. Interest rate risk refers to the probability that changes in interest rates will negatively affect earnings. Assets of credit unions are often invested in vehicles that have a limited ability to generate higher returns despite increases in market rates of interest. Loans are often subject to legal interest rate ceilings, and other funds may be invested in intermediate- or long-term fixed-rate loans or securities. Such assets are often funded through short-term liabilities (deposits) that are highly sensitive to changes in interest rates. Since credit unions make investments and loans for extended periods of time, an inability to match rate-sensitive assets with similarly rate-sensitive liabilities may cause interest rate margins to decrease or disappear entirely. 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 high 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. Steps taken to neutralize exposure to interest rate risk frequently result in minimized earning potential. Fluctuations in market interest rates may also affect management's intent and ability to hold securities and loans until they mature and thus expose credit unions to the risk of reduced net interest margins.

Liquidity Risk

2.09 Liquidity risk refers to the probability that a credit union will not have funds available to repay fully all maturing liabilities on a timely basis. Credit unions are exposed to liquidity risk when they invest disproportionately in non-readily marketable securities or other non-readily marketable assets, which generally decrease in market value when interest rates rise. If a credit union is forced to sell such investments or to borrow to generate cash, losses or interest expense may be incurred. The auditor should evaluate the composition of members' deposits to assess 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.

Risk Management

2.10 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. For example, 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 negative gap will generally experience decreased earnings.

Knowledge of the Client's Business

2.11 To plan and perform an audit properly, the auditor should have knowledge of aspects that are unique to the entity whose financial statements are being audited. Such aspects include matters such as organizational structure, product lines and services, capital structure, locations, and other operating characteristics. The auditor's knowledge of the client's business should be sufficient to enable him or her to understand the events, transactions, and practices that, in his or her judgment, may have a significant effect on the financial statements.

2.12 Knowledge of the client's business is generally obtained through experience with the client and discussions with other auditors or client personnel. Such knowledge may also be obtained or supplemented by performing procedures such as (*a*) reviewing the charter and bylaws of the credit union and (*b*) reading minutes of meetings of the board of directors, the supervisory committee, the credit committee or the loan officers or both, and other appropriate committees.

2.13 In obtaining knowledge of a client's business, the auditor should be aware of the possible existence of related parties. FASB Statement No. 57, *Related Party Disclosures,* defines *related parties* as—

- Affiliates of the enterprise (a party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an enterprise).
- Entities for which investments are accounted for by the equity method by the enterprise.
- Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management.
- Principal owners of the enterprise.
- Management.
- Members of the immediate families of the principal owners of the enterprise and its management.
- Other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party is also a related party if it can significantly influence the management or operating policies of the transacting parties, or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

2.14 Determining the existence of related parties and identifying transactions with them requires the application of specific procedures. Guidance concerning such procedures is contained in SAS No. 45, *Omnibus Statement on Auditing Standards—1983,* "Related Parties," paragraphs 7 and 8. When auditing identified related party transactions, the auditor should be aware

that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of a particular transaction rather than merely its form. In addition, if the client includes a representation in the financial statements that related-party transactions are equivalent to arms-length transactions and the auditor believes that the representation is unsubstantiated by management, he or she should express a qualified or adverse opinion because of a departure from GAAP.

Internal Control Structure

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

2.16 A credit union's internal control structure consists of three elements: the control environment, the accounting system, and control procedures. There are several procedures peculiar to the credit union industry that, if in place and functioning properly, strengthen the internal control structure. They include the following:

- 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

In all audits, the auditor should obtain a sufficient understanding of each of the three elements to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

2.17 After obtaining this understanding, the auditor assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. The auditor may assess control risk at the maximum level (the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control structure) because he or she believes policies and procedures are unlikely to pertain to an assertion or are unlikely to be effective, or because evaluating their effectiveness would be inefficient. Alternatively, the auditor may obtain evidential matter about the effectiveness of both the design and operation of a policy or procedure that supports a lower assessed level of control risk. Such evidential matter may be obtained from tests of controls planned and performed concurrently with obtaining the understanding or from procedures performed to obtain the understanding that were not specifically planned as tests of controls.

2.18 After obtaining the understanding and assessing control risk, the auditor may desire to seek a further reduction in the assessed level of control risk for certain assertions. In such cases, the auditor considers whether evidential matter sufficient to support a further reduction is likely to be available and whether performing additional tests of controls to obtain such evidential matter would be efficient.

2.19 The auditor uses the knowledge provided by the understanding of the internal control structure and the assessed level of control risk in determining the nature, timing, and extent of substantive tests for financial statement assertions.

2.20 The auditor may find useful guidance in section 5140, "Internal Controls," of the NCUA's *Accounting Manual for Federal Credit Unions*, which describes the basic elements of the internal control structure of credit unions. Subsequent chapters of this guide summarize control procedures and conditions that the auditor may wish to consider when assessing control risk in connection with an audit of a credit union's financial statements.

Data Processing Provided by Independent Organizations

2.21 Many credit unions use some form of data processing that is provided by an independent organization (see chapter 12). Guidance on auditing records where third-party services are significantly involved with data processing is contained in (*a*) SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*, and (*b*) the AICPA Audit Guide *Consideration of the Internal Control Structure in a Financial Statement Audit*.

Analytical Procedures

2.22 SAS No. 56, *Analytical Procedures*, provides guidance on the use of analytical procedures in audits performed in accordance with generally accepted auditing standards and mandates the use of analytical procedures in both the planning and review stages of all audits. For planning purposes, analytical procedures generally focus on (*a*) enhancing the auditor's understanding of the client's business and the transactions and events that have occurred since the last audit and (*b*) identifying areas that may present specific risks relevant to the audit. The objective of analytical procedures in audit planning is to identify unusual transactions or events that may require particular audit attention as well as trends or ratios that might indicate matters that have financial statement or audit planning ramifications.

2.23 Analytical procedures involve comparison of recorded amounts or ratios developed from recorded amounts to expectations developed by the auditor. Examples of analytical procedures that auditors may find useful in planning an audit of a credit union include comparison of account balances with budgeted and prior-period amounts as well as analysis of ratios that indicate relationships among elements of financial information within the period and relationships to similar information about the industry in which the entity operates. Significant ratios relevant to credit unions include—

- *Share growth*—Current-period shares less prior-period shares divided by prior-period shares. Share growth is an indicator of the credit union's ability to compete for member's savings. Growth in excess of the interest rate indicates real growth.
- *Loans to assets*—Total loans divided by total assets. This ratio measures the percent of assets invested with the membership.
- *Equity growth*—Current-period capital (total reserves and undivided earnings) less prior-period capital divided by prior-period capital. A positive ratio indicates growing equity and enhancement of a credit union's ability to absorb losses.

- *Capital*—Capital and total shares divided by total shares. This ratio is a traditional measure of financial strength without consideration for potential losses. In general, the higher the percentage the greater a credit union's financial strength.
- *Delinquent loans*—Delinquent loans to total loans. This ratio measures past-due loan risk. A high ratio is cause for concern and indicates increased potential for future losses on loans.
- *Classified assets to capital*—Classified assets divided by capital. This ratio measures the credit union's total ability to absorb current losses.
- *Loan loss ratio*—Net loans charged off divided by average loans. Increasing loan chargeoffs may be an indicator of ineffective lending and loan collection practices.
- *Liquidity ratio*—Liquid assets divided by short-term liabilities and shares. This ratio measures the ability of the credit union to meet liquidity needs. A low ratio indicates a limited ability to meet liquidity demands.
- *Yield on assets*—Gross income for the period divided by average assets (the average of the previous and current period's assets). This ratio measures the yield earned on the credit union's assets.
- *Operating expenses to assets*—Operating expenses less the provision for loan losses and cost of funds (cost of borrowed money, dividends, and interest) divided by average assets. This ratio measures the relative cost of operating the credit union.
- *Cost of funds to assets*—Cost of funds divided by average assets. This ratio measures the relative cost of a credit union's investment in its assets.
- *Net income (loss) from operations to assets*—Earnings after current period reserve transfers divided by average assets. This ratio measures the credit union's earnings on the assets invested in the business.

2.24 Sources of information that may be useful to auditors in developing expectations about recorded amounts and ratios include prior-period financial information and budgets. Auditors may also find useful information in interim financial reports prepared by management for use by the supervisory committee or for reporting to regulators.

Consideration of the Possibility of Material Misstatements

2.25 There are certain risks inherent in all audit engagements. One such risk is the possibility that the financial statements are materially misstated as the result of errors and irregularities or illegal acts by clients. SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities,* provides guidance on the auditor's responsibility for the detection of errors and irregularities in an audit of financial statements in accordance with generally accepted auditing standards. SAS No. 53 describes factors that influence the auditor's ability to detect errors and irregularities and explains that the exercise of due care should give appropriate consideration to the possibility of errors and irregularities. It also provides guidance on the auditor's responsibility to communicate detected matters both within and without the entity whose financial statements are being audited. Management, industry, or

engagement characteristics that may be indicative of increased risk of possible material misstatements in the audit of a credit union include the following:

- 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

2.26 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. *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. Insider abuse may involve unsound loans to insiders or related parties or even embezzlement of a credit union's funds. Factors that may indicate possible insider abuse include the following:

- Unsound lending practices
- Loans secured by collateral that has had recent, dramatic increases in value
- Loans of unusual size or with unusual interest rates or terms
- Poor loan documentation
- Loans with unusual or questionable collateral or collateral that is inconsistent with the credit union's normal underwriting practices
- Violations of legal limits on loans to one borrower
- Out-of-territory loans
- Loans that are continuously extended or modified
- Multiple transactions with a single party or a group of affiliated parties

Communications Between Independent Auditors and Regulators

2.27 Regulatory examination reports and related communications between examiners and a credit union can provide important information to auditors. For example, SAS No. 57, *Auditing Accounting Estimates,* states that the auditor should consider evaluating "information contained in regulatory or examination reports, supervisory correspondence, and similar materials

from applicable regulatory agencies." SAS No. 54, *Illegal Acts by Clients,* notes that "the auditor may encounter specific information that may raise a question concerning possible illegal acts, such as . . . violations of laws or regulations cited in reports of examinations by regulatory agencies that have been made available to the auditor." Accordingly, the auditor should review such reports and communications.

2.28 Policies of the NCUA and most state agencies that regulate credit unions have traditionally allowed a credit union's independent auditor access to certain confidential reports of examinations of the credit union. In addition, examiners generally have been permitted to provide pertinent information to the independent auditor with the prior approval of the credit union. Further, examiners have permitted the independent auditor, with the permission of the credit union, to attend, as an observer, the exit conference between examiners and the board of directors (or an appropriate board committee) or executive officers of the credit union or both.

2.29 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.

2.30 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 paragraph 7 of SAS No. 58, *Reports on Audited Financial Statements*). 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.

2.31 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. Further, 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.

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[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.

Compliance With Regulations

2.32 Paragraph 7 of SAS No. 22 states that in planning the audit, 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 [*emphasis added*]." In performing an audit in accordance with generally accepted auditing standards, the auditor considers government regulations in light of how they might affect the financial statement assertions.

2.33 The nature and extent of the auditor's consideration of possible violations of laws and regulations is described in SAS No. 54. SAS No. 54 provides guidance in dealing with acts that appear to be illegal, discusses the auditor's responsibility to detect and report misstatements resulting from illegal acts, and sets forth the auditor's responsibility for notification of other parties when possible illegal acts are detected. The auditor should be aware of the possibility that illegal acts that could have a material effect on the credit union's financial statements may have occurred. 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.

2.34 These laws and regulations include, for example, limitations on the nature and amount of certain investments. Because such laws and regulations 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.

2.35 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. In general, such laws and regulations relate more to an entity's operating aspects than to its financial and accounting aspects and their financial statement effect is indirect. Their indirect effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality. 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.

2.36 When planning and conducting the audit, the independent auditor should consider what impact noncompliance with various regulations may

have on a credit union. Examiners' reports may provide information about illegal acts. The independent auditor should review reports of significant examinations and related communications between examiners and the credit union.

Client Representations

2.37 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.

Going Concern Considerations

2.38 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* requires auditors to evaluate, as part of every audit, whether there is substantial doubt about the ability of the entity being audited to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. This section describes the unique issues that an auditor may encounter in evaluating a credit union's ability to continue as a going concern.

2.39 SAS No. 59 provides guidance to the auditor for meeting this responsibility of evaluation, which is accomplished through the following steps:

a. Consider whether the results of procedures performed in planning, gathering evidential matter relative to the various audit objectives, and completing the audit identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

b. If the foregoing considerations lead the auditor to believe that substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time, he or she should obtain information about management's plans that are intended to mitigate the adverse effects of the conditions or events that gave rise to the doubt, and assess the likelihood that such plans can be effectively implemented.

c. After evaluating management's plans, the auditor concludes whether he or she has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

2.40 SAS No. 59 states that it is not necessary to design audit procedures solely to identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the ability of an entity to continue as a going concern for a reasonable period of time. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose. The following are examples of procedures normally performed in audits of credit unions that may identify such conditions and events:

- Analytical procedures
- Review of subsequent events
- Review of compliance with the terms of debt and loan agreements
- Reading of minutes of meetings of the board of directors, and important committees of the board
- Inquiry of an entity's legal counsel about litigation, claims, and assessments
- Confirmation with related and third parties of the details of arrangements to provide or maintain financial support
- Review of reports of significant examinations and related communications between examiners and the credit union
- Review of compliance with regulatory capital requirements

2.41 In performing audit procedures such as those presented in paragraph 2.40 above, the auditor may identify information about certain conditions or events that, when considered in the aggregate, indicate there could be substantial doubt about the credit union's ability to continue as a going concern for a reasonable period of time. The significance of such conditions and events will depend on the circumstances, and some may have significance only when viewed in conjunction with others. Examples of such conditions and events that may be encountered in audits of credit unions include—

- Recurring operating losses.
- Indications of strained liquidity.
- Negative equity on a GAAP basis.

- Concerns expressed by regulatory authorities about alleged unsafe and unsound practices, including an LUA or its equivalent. A formal order by a regulatory agency to merge, close, or otherwise deal with a troubled credit union is generally preceded by a LUA.
- Indications of strained relationships between management and regulatory authorities.
- Noncompliance with regulatory capital requirements.

2.42 SAS No. 59 states that if, after considering management's plans, the auditor concludes there is substantial doubt about the credit union's ability to continue as a going concern for a reasonable period of time, the auditor should consider the possible effects on the financial statements and the adequacy of the related disclosure. Some of the information that might be disclosed includes—

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the credit union's ability to continue as a going concern for a reasonable period of time.
- The possible effects of such conditions and events.
- Management's evaluation of the significance of those conditions and events and any mitigating factors.
- Possible regulatory sanctions, including discontinuance of operations.
- Management's plans (including information about the credit union's capital plan and relevant prospective financial information).
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities.

2.43 If, primarily because of the auditor's consideration of management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time is alleviated, he or she should consider the need for disclosure in the financial statements of the principal conditions and events that initially caused him or her to believe there was substantial doubt. Disclosure should include the possible effects of such conditions and events, and any mitigating factors, including management's plans.

2.44 If the auditor concludes that substantial doubt about the credit union's ability to continue as a going concern for a reasonable period of time remains, the auditor's report should include an explanatory paragraph (following the opinion paragraph) to reflect that conclusion.

Chapter 3

Cash

Introduction

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

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

3.03 Cash on hand consists primarily of a change fund and petty-cash funds. A credit union's change fund is a supply of currency, 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.

3.04 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.

3.05 A credit union may also have consignment items (such as travelers' checks and money orders) that could easily be converted into cash and therefore should be controlled.

Financial Statement Presentation

3.06 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 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

3.07 The objectives of auditing cash and cash equivalents are to obtain reasonable assurance that—

- Recorded cash and cash equivalents exist and are owned by the entity at the statement of financial condition date.
- Cash balances are complete and accurate.
- Cash receipts, disbursements, and transfers have been recorded in the proper period and reconciling items will clear in the normal course of business.
- Cash balances are presented in the financial statements in accordance with generally accepted accounting principles.
- Cash restricted as to availability or use is properly identified and disclosed.

Planning Considerations

3.08 Cash may be a significant item to a credit union because of the large volume of transactions. Cash receipts consist primarily of 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. The principal documents initiating cash transactions are cash-received vouchers, checks used for disbursement purposes, and journal vouchers affecting cash.

Internal Control Structure

3.09 Because of the negotiability and liquidity of the items included in cash and cash equivalents, an effective internal control structure in this area is a significant audit concern. 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 receipt, 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.
- ATM access and balancing are subject to dual control.
- Bank accounts used for ATM transactions are reconciled on a daily basis.

3.10 Many credit unions use wire transfers to facilitate large cash transactions. Having an effective internal control structure over wire transfers is particularly important because of the risk of fraudulent wire-transfer activity. As wire-transfer activity increases, the auditor's assessment of control risk associated with wire transfer becomes an increasingly important concern. 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 reviews of third-party wire transfers are performed.

Tests of Controls

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

- Inquiring whether and observing that adequate segregation of duties exists with respect to the handling and reconciliation of cash.
- Inquiring about and reviewing documentation of surprise cash counts of teller and vault funds to determine that they are performed periodically.
- Inquiring about and observing that proper control of mail receipts and supplies of consigned items is maintained.
- Inquiring whether and inspecting reconciliations to determine that they are performed and reviewed in a timely manner.

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

- Reviewing transfers sent and received to determine that sequence numbers are unique and consecutive.

- Inquiring about and observing that acknowledgments are returned for all outgoing messages.
- Inquiring about and observing that 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.
- Reviewing reconciliations to determine that differences on daily-reserve or clearing-account statements are reconciled and any discrepancies are investigated.

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

Substantive Tests

3.14 The auditor should determine the nature, timing, and extent of substantive tests based on his or her assessment of inherent and control risks. Substantive tests that the auditor should consider include—

- Counting cash and comparing the balances with tellers' proof sheets.
- 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.
- Confirming consigned items with consignors.
- Scanning cash records for unusual transactions or adjustments.

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

Chapter 4

Investment Securities

Introduction

4.01 Credit union investment managers choose from a number of investment alternatives to achieve 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 one of the primary tasks of management.

4.02 Credit unions' 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. Credit unions' 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. In managing their investment portfolios, credit unions seek to maximize their returns without jeopardizing the liquidity the portfolios provide.

Investment Activities

4.03 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 agencies of the U.S. government.
- Mortgage-backed securities issued or fully guaranteed by an agency of the U.S. government.
- Privately issued mortgage-backed securities.
- Common trust or mutual investment funds.
- Investments in the Central Liquidity Facility.
- Investment deposits in federally insured financial institutions.
- Repurchase agreements.
- Mortgage-related derivatives, such as stripped mortgage-backed securities, collateralized mortgage obligations, and asset-backed security residuals, except asset-backed residuals supported by installment loans, leases, or revolving lines of credit.
- Investments in other natural person credit unions.
- Purchased put options related to loans held for sale.
- Federal funds purchased.
- Pair-off transactions (that is, matching or netting of commitments to purchase and sell securities via cash-forward agreements), subject to guidelines contained in NCUA Interpretive Ruling and Policy

Statement (IRPS) No. 92-1, *Supervisory Policy Statement on Securities Activities* (an interpretation of the FFIEC Policy Statement *Supervisory Policy Statement on Securities Activities,* February 1992).

- Other investments, as outlined in The Federal Credit Union Act, section 107; the NCUA *Rules and Regulations,* part 703, "Investment and Deposit Activities"; NCUA IRPS 92-1; or similar state statutes.

4.04 As a result of the failure or weakening of credit unions that have engaged in speculative investment practices, certain investment vehicles have been determined by regulators to be impermissible. The NCUA may require immediate disposal of unauthorized investments, which may result in substantial losses to the credit union. Unauthorized (prohibited) investments for a federal credit union currently include—

- 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 of the securities may vary. It is often very short, especially when securities with a ready market are involved. 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,* 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.
- Common stocks, except for those issued by credit union service organizations (CUSOs).
- Corporate debt obligations.
- Equity participations in commercial real estate projects.

The investment environment in which credit unions operate 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 be aware that other limitations may be imposed by state regulatory agencies with authority over state-chartered credit unions.

4.05 A brief discussion of several of the most common investment vehicles used by credit unions follows.

Corporate Credit Union Network

4.06 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 may be 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 offered through the Network include regular daily shares and overnight certificates. Term investment alternatives, with maturities of two days to five years and longer, offered through the Network include (*a*) liquidity, (*b*) high-yield and redeemable shares, and (*c*) variable-rate shares and certificates.

Debt Securities

4.07 The most common forms of investment securities held by credit unions are debt securities issued by the U.S. government or government-sponsored enterprises. Debt securities represent the issuers' promise to pay a set principal amount at a given maturity date, as well as interest, at either a fixed rate or a variable rate, during the term of the security.

Mortgage-Backed Securities

4.08 Mortgage-backed securities (MBSs) represent a participation in an organized pool of mortgages (single-family, multi-family, 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-family or multi-family.

Mortgage-Related Derivatives

4.09 Mortgage-related derivative products, or 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" because 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. The high-risk nature of these products stems, in part, 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 the prices of such securities might be expected to behave under various interest rate and prepayment scenarios.

Mutual Funds

4.12 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. In contrast to debt securities, the perpetual nature of open-ended mutual funds does not afford investors the opportunity to hold to maturity to ensure recovery of the initial investment (or a stated principal amount). Accordingly, investing in mutual funds poses a higher degree of principal risk.

Repurchase Agreements

4.13 Repurchase agreements (repos) are agreements 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 Reverse-repurchase agreements (RRPs or reverse repos) are agreements to sell and repurchase identical securities within a specified time at a specified price. Most of the risks faced by seller-borrowers entering into RRPs are also faced by buyer-lenders entering into repos. If a buyer-lender under a repo agreement with a securities dealer does not perfect a security interest in the 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 extends to the full value of the securities bought and the credit risk assumed is equivalent to that of an unsecured lender. Collateral risk to which the buyer-lender is exposed 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 is 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 Hedging instruments are financial products that are used to reduce interest rate risk. These products, when properly used, can reduce a credit union's risk of loss from volatile movements in interest rates. Hedging instruments generally provide for the transfer of interest rate risk to a third party.

Financial products commonly used as hedging instruments include interest rate futures contracts, options, and interest rate swaps. 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, they can expose credit unions 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 can protect a 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 or 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. 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 should be systematically adjusted to the amount anticipated to be realized at the maturity date and the amount of such periodic adjustments included in interest income. FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases,* requires that amortization of premium or accretion of discount be recorded in a manner that produces a constant rate of return on the basis of adjusted book value (interest method).

4.18 The period of amortization or accretion should extend from the purchase date to the maturity date. The use of maturity dates for determining the amortization period for mortgage-backed securities may not be necessary when credit unions hold a large number of similar loans for which prepayments are probable and the timing and the amount of the prepayments can be reasonably estimated. In such circumstances, credit unions may 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. However, if the settlement date for a purchase or sale occurs after the financial statement date, and (*a*) the purchases or sales do not significantly affect the composition of a credit union's assets 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 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.[2] Each of these categories requires a different accounting treatment, as discussed in the following paragraphs.

4.21 Assets held for investment are those investment securities that management has the intent and ability to hold to maturity. Assets held for investment should be accounted for at cost, adjusted for amortization of premiums or accretion of discounts. Only realized gains or losses should be recognized for purposes of determining income. FASB Statement No. 12, *Accounting for Certain Marketable Securities,* and an auditing interpretation of SAS No. 1, section 332, *Long-Term Investments* (AICPA *Professional Standards,* vol. 1, AU section 9332.09), require that when the market value of an investment security is less than cost, 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 recorded as a realized loss.

4.22 Assets held for sale should be valued at the lower of aggregate cost or market. Assets held for trading purposes 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. Such transfers should be recorded at amortized cost, and the lower-of-cost-or-market method should be applied immediately. If a specific 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 assets-held-for-sale account to the assets-held-for-investment account. Such transfers should be recorded 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.

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[2] In September 1992, the FASB issued an exposure draft of a proposed Statement, *Accounting for Certain Investments in Debt and Equity Securities,* which would address the accounting and reporting for investments in equity securities that have readily determinable fair values and for all investments in debt securities. The proposed statement would supersede FASB Statement No. 12, *Accounting for Certain Marketable Securities* and amend FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities,* to eliminate mortgage-backed securities from its scope. Readers should be alert for the issuance of final accounting standards issued by the FASB in this area.

4.26 Securities may be transferred to or from the assets-held-for-trading-purposes account; however, transfers from the assets-held-for-sale to the assets-held-for-trading-purposes account should be extremely rare. Such transfers should be recorded at market value at the date of transfer, and the market value should become the new cost basis for the securities. No gain should be recognized on such transfers; the amount by which such securities are written up, if any, should be deferred until the final disposition of the securities.

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

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 the statement-of-financial-condition captions described above. Securities that are pledged for borrowing or other purposes should also be disclosed in the financial statements or the notes thereto. In accordance with SOP 90-11, *Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets,* the notes to the financial statements should also disclose the following information concerning debt securities held as assets:[3]

- For each statement of financial condition presented, the amortized cost,[4] 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.[5]
- For each period for which results of operations are presented, the proceeds from the sales[6] of such debt securities and the gross realized gains and gross realized losses on such sales.

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[3] 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.

[4] 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.

[5] 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.

[6] 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

4.29 FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, requires credit unions to disclose, either in the body of the financial statements or in the accompanying notes, the fair value[7] of financial instruments for which it is practicable[8] to estimate fair value, and the method(s) and significant assumptions used to estimate the fair value of financial instruments.

4.30 FASB Statement No. 107 defines a financial instrument as cash, evidence of an ownership interest in an entity, or a contract that both (*a*) imposes on one entity a contractual obligation[9] (1) to deliver cash or another financial instrument to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity and (*b*) conveys to that second entity a contractual right (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

4.31 Quoted market prices, if available, are the best evidence of the fair value of financial instruments. If quoted market prices are not available, management's best estimate of fair value may be based on the quoted market price of a financial instrument with similar characteristics or on valuation techniques (for example, the present value of estimated future cash flows using a discount rate commensurate with the risks involved, option pricing models, or matrix pricing models). Appendix A of FASB Statement No. 107 contains examples of procedures for estimating fair value.

4.32 In estimating the fair value of deposit liabilities, a credit union should not take into account the value of its long-term relationships with depositors, commonly known as "core deposit intangibles." Core deposit intangibles are separate intangible assets, not financial instruments. For deposit liabilities with no defined maturities, the fair value to be disclosed should be the amount payable on demand at the reporting date. FASB Statement No. 107 does not prohibit an entity from disclosing separately the estimated fair value of any of its nonfinancial intangible and tangible assets and nonfinancial liabilities. For trade receivables and payables, no disclosure is required when the carrying amount approximates fair value.

4.33 If it is not practicable for an entity to estimate the fair value of a financial instrument or a class of financial instruments, the following shall be disclosed:

a. Information pertinent to estimating the fair value of that financial instrument or class of financial instruments, such as the carrying amount, effective interest rate, and maturity

b. The reasons why it is not practicable to estimate fair value

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(Footnote Continued)

maturity that market risk is substantially eliminated as a pricing factor may be excluded from this disclosure.

[7] FASB Statement No. 107 defines *fair value* as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. If a quoted market price is available for an instrument, the fair value to be disclosed for that instrument is the product of the number of trading units of the instrument times that market price.

[8] In the context of FASB Statement No. 107, "practicable" means that an estimate of fair value can be made without incurring excessive costs.

[9] *Contractual obligations* encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual obligations that are financial instruments meet the definition of *liability* set forth in FASB Concepts Statement No. 6, *Elements of Financial Statements,* although some may not be recognized as liabilities in financial statements—may be "off-balance-sheet"—because they fail to meet some other criterion for recognition. For some financial instruments, the obligation is owed to or by a group of entities rather than a single entity.

4.34 *Mortgage-Backed Securities.* The accounting treatment accorded to mortgage-backed securities (MBSs) parallels that of other investments. MBSs held for investment should be reported at amortized cost (that is, cost adjusted for amortization of premium or discount and prepayments). MBSs held for sale should be 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 should be accounted for as a valuation allowance. Changes in the valuation allowance should be included in the determination of the net income of the period in which the change occurs. MBSs held in trading accounts should be reported at market value. Changes in the market values of such MBSs should be accounted for as adjustments to the recorded investment.

4.35 Investments in mortgage-backed securities should usually be reported separately in the statement of financial condition, rather than be 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.

4.36 *Mortgage-Related Derivatives.* Mortgage-related derivatives include interest-only certificates, principal-only certificates, and asset-backed residuals.

4.37 *Interest-only certificates* (IOs) are mortgage-backed securities in which investors purchase 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 Emerging Issues Task Force (EITF) reached a consensus in EITF Issue No. 89-4, *Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate,* that mortgage-backed IOs should be accounted for in the same manner as high-risk non-equity CMO instruments.[10] The EITF also reached a consensus that interest income on an investment in an IO 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).

4.38 The anticipated annual effective yield, or internal rate of return, on an IO should be 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 income is calculated on the investment balance using the effective yield. Cash received is applied to accrued interest, and any excess cash is used to reduce the investment balance. At the end of each subsequent reporting period, the effective yield is recalculated based on the amortized cost of the investment and expected future cash payments that reflect revised assumptions about prepayment rates.

4.39 *Principal-only certificates* (POs) are similar to IOs, except that investors purchase a portion or all of the cash flows of a mortgage-backed security designated as principal. In general, purchase discounts are recognized by the interest method over the contractual life of the related instrument, in accordance with FASB Statement No. 91. Prepayments may be estimated in the application of the interest method if the criteria of paragraph 19 of FASB

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[10] Credit unions may sometimes invest in interest-only certificates that are not mortgage-related derivatives. An example of such an IO is interest-only strips of U.S. government bonds. Such IOs are not considered high-risk and should be accounted for in accordance with FASB Statement No. 91.

Statement No. 91 are met. POs derived from MBSs ordinarily meet those criteria.

4.40 *Asset-backed residuals* represent the excess cash flows from asset-backed securities transactions after the payments due to bondholders and administrative expenses have been satisfied. Asset-backed residuals 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 in an asset-backed residual.

4.41 Accounting for purchased investments in CMO residuals is discussed in EITF Issue 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 (ARB) No. 51, *Consolidated Financial Statements*, as amended by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*.

4.42 The financial statement presentation of investments in mortgage-related derivatives varies in practice. In general, mortgage-related derivatives are included with "Mortgage-Backed Securities" or "Investments" on the face of the statement of financial condition. If sufficiently material, they should be presented separately.

4.43 When a credit union invests in mortgage-related derivatives, the notes to its financial statements 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 necessary to disclose unusual risk characteristics. The disclosure requirements described in paragraph 4.27 also apply to mortgage-related derivatives.

4.44 When a credit union invests in mortgage-related derivatives, the summary of significant accounting policies should describe the method of accounting for investments in mortgage-related derivatives, as well as disclose significant factors, such as prepayments and interest rates, that may affect the yield on, or recoverability of, the carrying amount.

4.45 *Mutual Funds*. Open-ended mutual funds are considered marketable equity securities. Marketable equity securities held for investment or for sale should be accounted for at the lower of aggregate cost or market value in accordance with FASB Statement No. 12. Marketable equity securities held for trading purposes should be accounted for at market value.[11] The amount

[11] See footnote 2.

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.

4.46 *Repurchase Agreements.* Repurchase agreements (repos) should be accounted for in the same manner as reverse repos, 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. As of the end of the period:
   - 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.[12] 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.[13] If concentrations at the end of the period vary from those during the period, consideration should be given to disclosing this information.

b. For the period:
   - 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.

4.47 *Hedging Instruments.* As discussed previously, the only hedging instrument available to federal credit unions is purchased put options on loans held for sale in the secondary market. AICPA Issues Paper 86-2, *Accounting*

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[12] *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.

[13] *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's loss exposure if it lacks control over the collateral in a repurchase transaction is different from its loss exposure 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, or for the benefit, of the credit union by an independent third party and if condition *b* is met. Lack of control exposes the credit union to risk of loss of the amount invested.

for Options, contains several advisory conclusions of the AICPA's Accounting Standards Executive Committee (AcSEC). 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.

4.48 Options may be used by credit unions to hedge exposures to market 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.

4.49 Certain investments may be included as cash equivalents in the financial statements of a credit union. Cash flows relating to investments are usually classified along with investing activities or operating activities in the statement of cash flows. See chapter 14 for a further discussion of the presentation of investment information in the statement of cash flows.

Off-Balance-Sheet Risks

4.50 FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk,* 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. These disclosure requirements are discussed in paragraphs 5.48 and 5.49 of this guide.

Audit Objectives and Procedures

Audit Objectives

4.51 The objectives of auditing investments are to obtain reasonable assurance that—

- Investments exist and are either on hand or held in safekeeping or custody for the credit union.
- All investments owned by the credit union and all investment transactions during the period are included in the investment accounts.
- The credit union has legal title or similar rights of ownership for all investments at the statement-of-financial-condition date.
- The values at which investments are reported in the financial statements are appropriate in accordance with generally accepted accounting principles.
- Legal and regulatory provisions (such as restrictions on the types of securities that may be owned and requirements to dispose of certain securities) have been considered in valuing securities.
- Realized and unrealized gains and losses on sales of investments and unrealized gains and losses on investments held for sale or in a trading portfolio are properly measured, recorded, and disclosed in accordance with generally accepted accounting principles.
- Interest income on investments and the related statement-of-financial-condition accounts (accrued interest receivable, unearned discount, and unamortized purchase premiums or discounts) are

properly measured, recorded, and disclosed in accordance with generally accepted accounting principles.

- Investments are properly reported in the financial statements, and the related note disclosures are adequate.

Planning Considerations

4.52 *Audit Strategy.* The nature, timing, and extent of substantive tests that the auditor applies to achieve the audit objectives, as well as tests of controls, are based on the auditor's assessment of the inherent risk characteristics associated with the investing activities the credit union engages in and the types of investments the credit union holds. The auditor's assessment of those risks, which may have both auditing and accounting implications, is especially important when the credit union's investment portfolio includes complex or highly sophisticated financial instruments such as mortgage-backed securities, mortgage derivatives, or repurchase and reverse-repurchase agreements. Business risk, credit risk, market risk, and collateral risk are present to some degree in virtually all investments.

- Business risk represents the possibility that an investor does not properly understand the terms and economic substance of an investment vehicle. Such misunderstandings can result in incorrect pricing of securities, improper accounting for the investment or income derived from it, or unrealistic expectations about the marketability or liquidity of an investment.
- Market risk refers to the possibility that an investor may be unable to hold an investment made with borrowed funds because of declines in market price. Losses may result if the investor is forced to liquidate an investment sooner than intended.
- Credit risk refers to the possibility of default, either by an issuer of securities or by a financial institution that holds securities as a custodian or that has an obligation to deliver securities sometime in the future.
- Collateral risk represents the possibility that the custodian of securities in which the investor has not perfected an interest may not be able to deliver the securities.

4.53 Investments are often 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. In developing an audit strategy for the investments of a credit union, the auditor should consider reading interim financial statements, investment policies, and other financial information related to investments. The auditor should also consider management's policies and procedures for classifying investments 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 review 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 prepay-

ment 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 SAS No. 55 states that the auditor should obtain a sufficient understanding of each of the elements of the internal control structure to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation. 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 registered 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 are investigated and resolved; completed reconciliations are reviewed and approved by appropriate supervisory personnel on a timely basis.
- Authorized lists of signatures and brokers exist, are adhered to, and are 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.
- Management periodically compares buy and sell orders to brokers with brokers' advice.
- 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.
- Investments 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 to determine that the credit union has complied with relevant laws and regulations.
- For hedging instruments, the internal control policies and procedures address (*a*) transaction limits, (*b*) accreditation of brokers, (*c*) segregation of duties, and (*d*) reconciliations.

Some of the control procedures for investments may be performed directly by management. While management's close attention to investment transactions can be an effective factor in the control structure, the auditor should be alert to potential abuses and overrides of policies and procedures when such circumstances exist.

Tests of Controls

4.56 After obtaining the requisite understanding of internal control structure policies and procedures relating to investments, the auditor assesses control risk for the financial statement assertions that pertain to investments. Based on that understanding, the auditor may conclude that the policies and procedures that have been placed in operation are unlikely to be effective or that evaluating their effectiveness is unlikely to be efficient and, for that reason, assess control risk at the maximum level. In other circumstances, the auditor may decide that evidential matter to support a reduction in the level of control risk is likely to exist and that performing tests of controls to obtain such evidence will result in a more efficient audit approach. 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 with 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 whether 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.
- Observing or otherwise obtaining evidence that adequate segregation of duties exists among those who approve, have access to, record, and reconcile investments.

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 statement-of-financial-condition date, noting that the securities are registered in the credit union's name. Confirmation should be obtained of any securities pledged by or held for the credit union by custodians.

4.58 *Valuation.* In determining whether securities are properly valued as of the financial statement date, the auditor should evaluate management's classifications of investment securities as held-for-trading-purposes, held-for-sale, or held-for-investment 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 and ability to hold those securities to maturity. In evaluating the propriety of management's classification of investments, the auditor should also consider 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 assets held for investment, amortized cost should be tested by recomputation. Market values of assets held for trading purposes, and of those assets held for investment and held for sale that are recorded at the lower of aggregate cost or market value, should be tested by reference to 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 and the conditions that gave rise to the decline in value in accordance with the auditing interpretation of SAS No. 1, section 332, *Long-Term Investments* (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.

SAS No. 56 provides that 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 the 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 for propriety changes in the valuation allowance account (for investments held for sale) during the period.
- 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

5.01 Loans usually generate the largest portion of a credit union's revenue and represent the most significant component of its assets. Federal and state regulations generally restrict loans to credit union members only. In addition to interest income, loans 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.

5.02 One of the principal risks inherent in lending is the possibility that a borrower will not be able 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, the rate of economic growth, trends in local markets, and the financial stability of the sponsor group. Internal factors such as underwriting practices, familiarity and experience with loan products, the relative mix of and concentrations in 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.

5.03 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.

5.04 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. Loan servicing and related matters are discussed from the seller's perspective in chapter 7.

Types of Loans

5.05 Loans can be classified in a number of ways. The most common classification of loans is by purpose of the loan. Loans can also be classified by form (that is, the type of collateral or terms of repayment). Classifications by form commonly found in the credit union environment include the following:

- Installment (paragraph 5.07)
- Demand (paragraph 5.12)
- Time (paragraph 5.13)
- Term (paragraph 5.14)

5.06 *Consumer Loans.* Consumer loans represent the largest portion of the loan portfolio of most credit unions. Consumer loans are loans to individuals 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. Most consumer loans are made in the form of installment loans.

5.07 *Installment Loans.* Installment loans are almost always made on a simple interest basis. The loan 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.

5.08 *Real Estate Loans.* Real estate loans are generally secured by first or second mortgages and may extend for periods of up to forty years. In granting real estate loans, credit unions may use underwriting guidelines (such as those of FNMA, GNMA, the Department of Veterans Affairs [DVA], and FHLMC) that allow credit unions to participate in secondary markets. Repayment terms of real estate loans customarily require monthly payments of principal and interest, with interest determined 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.

5.09 Real estate mortgage loans are generally limited to 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).

5.10 Credit unions also grant loans to finance construction. Construction loans generally are granted only after the borrower has arranged for long-term financing upon completion of the construction (a takeout commitment). Although usually secured by real estate, construction loans generally entail more risk than real estate loans on improved property.

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 may be 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. A line of credit is a variation of a time loan 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.* Credit unions sometimes originate real estate loans with the intent to sell them in secondary markets. Some credit unions

manage interest-rate risk by selling fixed-rate real estate loans while retaining variable-rate real estate loans and non-real-estate fixed- and variable-rate loans.

Accounting Principles: Measurement and Disclosure

5.16 Loans held until maturity or payoff are generally 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). Credit unions that have both the ability and the intent to hold the loans for the foreseeable future or until maturity or payoff do not customarily recognize declines in value resulting from interest-rate fluctuations. Nonetheless, an allowance for loan losses is still required to reduce loan balances to their collectible amounts.

5.17 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.

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 in their loan portfolios. They may also purchase eligible loans of liquidating credit unions' 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 third parties. 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, gains or losses on sales of loans are measured by calculating the difference between the selling price and the carrying amount of the loans sold. 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, such loans should be reclassified and disclosed as loans held for sale and reported at the lower of cost or market value. See paragraphs 7.08 through 7.13 for further discussion of accounting for sales of loans. If a transfer of loans with recourse qualifies to be recognized as a sale, all probable adjustments in connection with recourse obligations to the transferor should be accrued in accordance with FASB Statement No. 5, *Accounting for Contingencies.* The measurement of the recourse obligation is currently being addressed by the FASB's EITF in EITF Issue No. 92-2, *Measuring Loss Accruals by Transferors for Transfers of Receivables with Recourse.* If a transfer does not qualify to be recognized as a sale, the cash received in the transaction should be accounted for as a secured borrowing.

5.20 Because of the variety of arrangements under which loan participations are purchased, it is important to consider the terms of the purchase, the effective yield to the purchaser, and the arrangements for servicing in addition to the stated purchase price. 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 equals 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. Such premiums and discounts should be accounted for in accordance with FASB Statement No. 91.

5.21 *Sales With Recourse.* Credit unions sometimes enter into loan sale agreements that provide recourse to the seller under certain conditions. For example, a seller may be required to make full or partial payment to the purchaser if the debtor fails to pay when payment is due. Similarly, a seller may be required to make payments to the purchaser as the result of loan prepayments or because of adjustments resulting from defects (such as failure to perfect a security interest in collateral) of the transferred loans. 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. If a transfer of loans with recourse qualifies to be recognized as a sale, all probable adjustments in connection with recourse obligations to the transferor should be accrued in accordance with FASB Statement No. 5. The measurement of the recourse obligation is currently being addressed by the FASB's EITF in EITF Issue No. 92-2. If a transfer does not qualify to be recognized as a sale, the cash received in the transaction should be accounted for as a secured borrowing.

5.22 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.

Troubled-Debt Restructurings

5.23 The provisions of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* [14] are required to be applied in accounting for troubled-debt restructurings. FASB Statement No. 15 prescribes that a modification of terms of a loan receivable should be accounted for prospectively and not as a change in the recorded investment in the receivable unless total future cash receipts 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 should be 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.

In-Substance Foreclosures

5.24 Practice Bulletin No. 7, *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed,* as amended by Practice Bulletin No. 10, *Amendment to Practice Bulletin 7,* Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed, 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.

5.25 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.

5.26 *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.

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[14] In June 1992 the FASB issued an exposure draft of a proposed Statement, *Accounting by Creditors for Impairment of a Loan,* which would amend FASB Statement No. 15 to require a creditor to account for a troubled-debt restructuring involving a modification of terms at fair value as of the date of the restructuring. A final Statement is expected by mid-1993.

[15] *Fair value* is defined in paragraph 13 of FASB Statement No. 15 as "the amount that the [creditor] could reasonably expect to receive for them in a current sale between a willing buyer

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, the economic prospects for the debtor or the collateral, or both, it is doubtful in the foreseeable future that the debtor will be able to rebuild equity in the collateral or otherwise repay the loan in the foreseeable future.

5.27 *Financial Reporting.* If all the criteria in paragraph 5.26 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 loans 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. Accounting for in-substance foreclosed assets after foreclosure is described in paragraphs 10.10 through 10.13.

5.28 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 5.26 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 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.

5.29 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.

5.30 Practice Bulletin No. 7 notes that AcSEC expects that the applicability of paragraph 5.28 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.

(Footnote Continued)

and a willing seller, that is, other than in a forced or liquidation sale. Fair value of assets shall be measured by their market value if an active market for them exists. If no active market exists for the assets transferred but exists for similar assets, the selling prices in that market may be helpful in estimating the fair value of the assets transferred. If no market price is available, a forecast of expected cash flows may aid in estimating the fair value of assets transferred, provided the expected cash flows are discounted at a rate commensurate with the risk involved." Some factors that may be relevant in estimating the fair value of various kinds of assets are described in paragraphs 88 and 89 of APB Opinion No. 16, *Business Combinations,* paragraphs 12-14 of APB Opinion No. 21, *Interest on Receivables and Payables,* and paragraph 25 of APB Opinion No. 29, *Accounting for Nonmonetary Transactions.* The AICPA *Guide for the Use of Real Estate Appraisal Information* provides guidance on evaluating appraisals of real estate used to determine fair value.

5.31 *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 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. This determination 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 5.26 likely will be met.

5.32 The second criterion in paragraph 5.26 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 5.26, the collateral should be considered to have been in-substance foreclosed.

5.33 In evaluating part 2 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.

5.34 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]

5.35 FASB Statement No. 15 requires that assets acquired in full satisfaction of a receivable 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. After foreclosure, assets should be accounted for in accordance with SOP 92-3, *Accounting for Foreclosed Assets,* which is discussed further in chapter 10.

Allowance for Loan Losses

5.36 Management is responsible for maintaining an adequate allowance for loan losses applicable to all categories of loans. The accounting and auditing considerations related to the allowance for loan losses are discussed in chapter 6.

Interest Income

5.37 Interest income should be accrued using the interest method as it is earned. The accrual of interest income should be discontinued, and previously

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

accrued interest receivable should be reversed, when it is determined that collection of accrued interest or any amount of principal is doubtful. 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 from loan proceeds during the construction period, the credit union should periodically assess the net realizable value of the underlying collateral to ensure that the amount of interest capitalized does not exceed the amount that can be realized from the sale of the project.

5.38 NCUA guidelines state that loans delinquent for three months or more should be placed on nonaccrual status and that accrual 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. State regulators may also have specific requirements for the discontinuance and reversal of accrued income. Such guidelines and requirements may result in conflicts with GAAP.

Loan Fees and Costs

5.39 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. FASB Statement No. 91 establishes accounting principles for nonrefundable fees and costs associated with lending, committing to lend, or purchasing a loan or group of loans. FASB Statement No. 91 specifies that—

- Loan origination fees should be recognized over the life of the related loan as an adjustment of yield.
- Certain direct loan-origination costs should be recognized over the life of the related loan as a reduction of the loan's yield.
- All loan-commitment fees should be deferred except for certain retrospectively determined fees; commitment fees meeting specified criteria should be recognized over the loan-commitment period; all other commitment fees should be recognized as an adjustment of yield over the related loan's life or, if the commitment expires unexercised, recognized in income upon expiration of the commitment.
- Loan fees, certain direct loan-origination costs, and purchase premiums and discounts on loans should be recognized as an adjustment of yield generally by the interest method, based on the contractual terms of the loan. However, prepayments may be anticipated in certain specified circumstances.

5.40 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 direct costs of completed loans and should be deferred irrespective of the existence of related loan fees. Direct costs of unsuccessful loans and all indirect costs should be charged to expense as incurred. Credit card fees should be amortized on a straight-line basis over

the period the fee entitles the cardholder to use the card,[17] and reported as service fee income.

5.41 *Purchased Loans.* FASB Statement No. 91 recognizes that credit unions may originate loans or purchase them from another source. The initial investment in a purchased loan or group of loans should include the amount paid to the seller plus any fees paid or less any fees received. All other costs related to the purchase of loans should be charged to expense as incurred. Premiums and discounts on purchased loans should be recognized as an adjustment of yield over the life of the loan. Paragraph 19 of FASB Statement No. 91 sets forth conditions that, if present, allow credit unions to consider estimates of future principal prepayments in calculating such yield adjustments. 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.

5.42 *Refinancings or Restructurings.* FASB Statement No. 91 states that the accounting for net fees or costs related to refinancings or restructurings should be based on a determination as to 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.

5.43 FASB Statement No. 91 states that the amortization of net fees or costs, as well as purchase premiums and discounts on all interest-earning assets, as yield adjustments, should be calculated using the interest method. Prepayments should not be 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.

5.44 FASB Statement No. 91 also provides guidance on accounting for fees and costs related to loans with no scheduled payment terms (demand loans) and revolving lines of credit. The Statement stipulates that net deferred fees and costs on demand loans should be recognized on a straight-line basis over (*a*) a period 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 should be 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

5.45 Loans are normally presented as a separate line item in the statement of financial condition in an aggregate amount. The allowance for loan losses and net unamortized deferred fees or costs may be presented either in a note to the financial statements or separately on the face of the statement of financial condition. Loans held for sale should be reported separately on the face of the statement of financial condition at the lower of cost or market value.

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[17] The EITF is currently addressing this matter in Issue No. 92-5, *Amortization Period for Net Deferred Credit Card Origination Costs.*

[18] See footnote 3.

5.46 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 concentrations. 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 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.

5.47 FASB Statement No. 107 requires disclosure of the fair value of financial instruments. Paragraphs 4.29 through 4.33 describe the required disclosures.

5.48 FASB Statement No. 105 requires that credit unions disclose significant concentrations of credit risk arising from all financial instruments, whether from an individual counterparty or groups of counterparties. Group concentrations of credit 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. Credit unions, because of their unique field of membership requirements, may experience significant concentrations of credit risk. FASB Statement No. 105 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 information about the extent, nature, and terms of financial instruments with off-balance-sheet risk by class of financial instrument. Information that should be disclosed includes—

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 if 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.

Items *a* and *b* of this paragraph should be disclosed for financial instruments with off-balance-sheet market or credit risk, and items *c* and *d* should be disclosed for financial instruments with off-balance-sheet credit risk. 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 Commitments to originate loans in the ordinary course of business and to purchase or sell loans generally have no immediate accounting effect on 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 above. 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.

5.51 Credit unions may sometimes make loans to directors and officers. Such loans are often made in the normal course of business and may be 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. FASB Statement No. 57 provides additional guidance on related-party transactions.

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 in the financial statements of a credit union should include a description of—

- 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

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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.

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 objectives of auditing loans are to obtain reasonable assurance that—

- Loans exist and are owned by the credit union as of the date of the financial statements.
- All loan transactions are recorded in the proper period.
- Interest income and the related statement-of-financial-condition accounts (accrued interest receivable and unamortized net deferred loan fees or costs) are measured and recorded in accordance with generally accepted accounting principles.
- Gains and losses on the sale of loans are measured and recorded in accordance with generally accepted accounting principles.
- Loans are valued, classified, described, and disclosed in the financial statements in accordance with generally accepted accounting principles.

Internal Control Structure

5.55 SAS No. 55 states that the auditor should obtain an understanding of the control environment, the accounting system, and control procedures relating to lending activities that is sufficient to plan the audit. The auditor's understanding of the internal control structure policies and procedures that relate to the lending process should include the policies and procedures over such transactions as granting credit, disbursing loan funds, applying loan payments, amortizing discounts, and accruing interest income. 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. Environment factors that should be considered include—

- A supervisory committee and board of directors that take an active role in monitoring lending policies and practices.
- The existence of a well-defined lending-approval system that includes established credit limits, limits and controls over the types of loans made, specified limits on maturities of loans, and policies on interest rates charged.
- A formalized reporting system that provides the credit union with the information needed to manage the loan portfolio and make business decisions.
- The existence of internal audit and loan review functions to identify existing and potential problem loans in a timely manner.

5.56 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 with 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; if any differences are found, they 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.
- Duties are segregated 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

5.57 Specific procedures the auditor should consider performing to test the operating effectiveness of internal control structure 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. (Such tests can also be substantive tests in that they provide evidence of the existence of loans and of 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 check the arithmetical accuracy of the reconciliations and determine whether reconciling differences are appropriately investigated and resolved and

whether the reconciliations are reviewed and approved by appropriate supervisory personnel.

- Checking the arithmetical accuracy, and performing a review, of reports detailing loans to one borrower and related-party loans.
- Observing, or otherwise obtaining evidence, that a proper segregation of duties exists among those who approve, have access to, record, and reconcile loans.

Substantive Tests

5.58 *Subsidiary Records.* The auditor should consider checking 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.

5.59 *Analytical Procedures.* SAS No. 56 provides guidance on the use of analytical procedures as substantive audit tests. Analytical procedures that the auditor may apply in the loan receivable area include—

- Reviewing changes in the mix of types of loans in the portfolio.
- Comparing new loan volume by period with volumes in prior periods.
- Comparing current-year income and accrued interest receivable amounts with expectations developed by the auditor and with prior-year amounts.
- Comparing yields on loans with established lending rates or pricing policies.
- Computing average yield throughout the period for each loan category on a monthly or quarterly basis.
- Considering any other relevant relationships.
- Comparing current-year average loan balances by type with prior-year amounts.

5.60 In using analytical procedures as a substantive test, the auditor should consider the implications of changes in important relationships and the amounts of differences 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.

5.61 *Inspection of Loan Documents.* Inspection of loan documents may help the auditor to obtain an understanding of the internal control structure policies and procedures sufficient to plan substantive tests and provides evidence about the existence of loans. The extent of the documentation reviewed by the auditor is a matter of judgment. Loan documents inspected by the auditor should include those supporting both old loans (those made before the period covered by the current audit) and new loans (including loans still in the process of disbursement).

5.62 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 govern-

mental 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. 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.

5.63 The content of loan files may vary significantly depending on the type of loan.

5.64 *Real Estate Mortgage Loans.* The extent of documentation supporting real estate mortgage loans depends in part on the requirements of local law. Typically, each real estate file should 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 and other credit information.
- 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, updated periodically if warranted by the circumstances (see NCUA *Rules and Regulations,* part 7.22).
- Deed of trust or mortgage.
- 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.

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

5.66 *Business Loans.* The basic documents supporting business loans generally include a signed note and credit information that includes the borrower's business, 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, including documentation supporting management's evaluation of the borrower's ability to repay the loan. The timely receipt and review of these documents provide 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.

5.67 *Consumer Loans.* Files supporting consumer installment loans generally include—

- A signed note.

- A 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. Such documentation may include a certificate of title showing the credit union as lienholder or a security agreement filed with the proper state agency.
- Insurance policies on collateral, naming the credit union as the loss payee.

5.68 *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 the treatment of classification and accounting. The auditor should consider testing origination, approval, inspection, and disbursement procedures. As construction progresses, the builder requests disbursements of portions of the loan proceeds. The credit union's control procedures should include a requirement that projects be inspected to determine that construction has progressed to the point permitting the requested disbursements. 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 projects.

5.69 *Confirmation of Loans.* Confirmation of loan balances and related information, including loan purchases and sales, is an effective way of gathering evidence of the ownership, existence, and accuracy of the recorded loan balances of a credit union. 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 loans of financial institutions) is a generally accepted auditing procedure. 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 tests of details are necessary to reduce audit risk to an acceptably low level for the applicable financial statement assertions.

An auditor who does not request confirmations of loan balances should document how he or she overcame the presumption that confirmations should be requested.

5.70 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 amounts of the payments, the interest rate, and the term of their loans.

5.71 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.

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

5.73 *Accrued Interest Receivable and Interest Income.* The auditor may 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 through the use of analytical procedures (for example, comparison of the current-year balance with the comparable prior-year balance). Interest income may also be tested by using monthly analytical tests by type of loan. The auditor should consider average balances in principal accounts, related yields as compared with rates offered and rates on existing loans, and other factors and relationships. Average rates may be obtained by using client-computerized records that have been tested for accuracy, or estimated by referring to a summary of loans by interest rate or other reasonable methods.

5.74 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 reports.

5.75 *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 with the servicer the actual status of borrower payments. 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 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.

5.76 *Whole Loans or Participations Sold.* Details of loans sold should be confirmed with participating institutions, including the balances of their investments, their 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.

5.77 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 sales during the period (including the recognition of a normal servicing fee in accordance with FASB Statement No. 65 and FASB Technical Bulletin No. 87-3) should be recalculated.

5.78 *Loan Classification.* The auditor should consider whether any portion of the credit union's loans is being held for sale and, if so, whether 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 policies 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.

5.79 *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.

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

Regulatory Restrictions

5.81 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 should discuss apparent noncompliance with management. SAS No. 54 prescribes the nature and extent of the consideration an independent auditor should give, in an audit of financial statements in accordance with generally accepted auditing standards, to the possibility of illegal acts by a client. The Statement also provides guidance on the auditor's responsibilities when a possible illegal act is detected.

Chapter 6

Allowance for Loan Losses

Introduction

6.01 The allowance for loan losses is an accounting estimate of credit losses inherent in a credit union's loan portfolio that have been incurred at the statement-of-financial-condition date. The objective of the allowance is to measure loans at their collectible amounts. Credit union management is responsible for the timely and periodic determination of the amount of the allowance required. Because the allowance is an estimate, it requires substantial judgment. The independent auditor is responsible for obtaining reasonable assurance that management, based on all available and relevant information affecting the loan portfolio,[21] has provided an adequate allowance.

6.02 Federal credit unions are required by part 702 of the NCUA *Rules and Regulations* to establish and maintain an allowance for loan losses. 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. The requirements for state-chartered credit unions that are not federally insured vary by state and insurer.

6.03 In chapter 5 the various types of loans credit unions make or buy, internal controls related to the lending process, financial reporting principles and practices for loans and related accounts, and auditing loans are discussed. Because of the significance of the allowance and the provision for loan losses to a credit union's financial statements, the high degree of subjectivity involved in estimating the allowance amount, the high degree of regulatory guidance and oversight directed toward credit unions' loan loss allowances, and consequently, the relatively high inherent risk associated with auditing the allowance, this separate chapter is dedicated to the allowance for loan losses. In this chapter relevant financial reporting principles, common loan loss reserve methodologies used by credit unions, regulatory influences, and auditing considerations are discussed.

Methods for Estimating Allowances for Loan Loss

6.04 Estimating the amount of the allowance is a highly subjective task, and accordingly, careful judgments about collectibility and estimates of loss must be made by credit union management. Management should consider past events (such as historical loss experience), current and anticipated economic conditions (such as those that may affect collateral values), and courses of action it expects to take. The judgments should be based on regular and detailed analyses of the loan portfolio. Loans held for sale are excluded from the loan portfolio when the allowance is determined because they are carried at the lower of cost or fair value.

6.05 Each credit union's method of estimating its allowance is dependent on many factors, including the credit union's size, business environment and strategy, management style, loan portfolio characteristics, loan administration

[21] The term *loan portfolio* refers primarily to loans, leases, and commitments to lend. In addition, credit unions may offer other financial products that contain elements of credit risk, and management should consider including the credit risk associated with these new financial products when determining the adequacy of the allowance for loan losses. The auditor's evaluation of the allowance for loan losses should also include an evaluation of off-balance-sheet financial instruments. The nature and amount of allowances or liabilities for losses related to off-balance-sheet financial instruments should be reported separately as prescribed by FASB Statement No. 105.

procedures, and data-processing systems. Accordingly, there are a variety of methods; no single method is considered preferable. However, it is important that the method is used consistently, is reasonable, is relevant to the credit union's particular circumstances, considers all loans (whether on an individual or pool-of-loan basis), considers the risks inherent in the different kinds of lending, considers current collateral values, is performed by competent and well-trained personnel, is based on current and reliable data, and involves the preparation of detailed and clear documentation of the analyses and rationale supporting the allowance amount. Methods that calculate the allowance as a percentage of total loans based on historical experience, or use similar allowance percentages of peer credit unions, would generally fail to meet those criteria because they do not involve a detailed analysis of a credit union's particular loans or consider the current economic environment.

6.06 A key element of most methodologies is a credit classification process. The classification process involves categorizing loans into pools and into risk categories. Each category should have similar characteristics, such as risk classification, past-due status, and type of loan. The categorization should be based on conditions (such as current financial information, historical experience, credit documentation, debt service record, public information, and current trends) that may affect the ability of the borrower or pool of borrowers to service their debt.

6.07 Management accumulates estimates of allowances for individual loans, pools of loans, and overall risks not attributable to particular loans or loan pools. Different methods for estimating the allowance are generally used for different categories of loans.

6.08 Pools of loans are generally evaluated on an aggregate basis. The focus is usually on loss experience for the pool rather than on analysis of individual loans. Loss experience, which is usually determined by reviewing the historical loss rate for each pool over a designated time period, is adjusted for changes in trends and conditions. The following are trends and conditions that credit unions consider in determining how, if at all, the historical loss rates should be adjusted:

- Levels of and trends in delinquencies and loans placed on nonaccrual status
- Trends in volume and terms of loans
- Effects of any changes in lending policies and procedures
- Experience, ability, and depth of the lending management's staff
- Economic trends
- Concentrations of credit

6.09 Loans not included in a pool should be analyzed individually. Most credit unions should have an internal loan review function. The loan review focuses on determining whether the loan is properly classified as to risk, conforms to the credit union's lending policies, and is likely to perform in accordance with its contractual terms and conditions. The review includes analysis of (*a*) loan performance since origination or the last renewal, (*b*) the current economic situation of a borrower or guarantor (for unsecured loans), and (*c*) appraisals of current fair values of collateral (for secured loans). Borrower or guarantor financial statements are generally reviewed for information about financial resources, liquidity, cash flows, and other information pertinent to the ability to repay the debt. Collateral is reviewed to determine whether it is under the credit union's control, whether security interests have been perfected, and whether the value is greater than the amount owed. Loan file contents are normally reviewed for conformity with the credit union's

lending policies, completeness, and to determine that required documents were obtained before the loan was approved. Internal loan review results should be documented and may be summarized in the form of ratings of individual loans, which is the basis for assessment of the collectibility of the loan.

6.10 Some credit unions use a method that results in a range of estimates for the allowance for individual loans and pools of loans. Such methods require that careful judgment regarding the risks, as well as other relevant factors for each range of amounts, be applied in determining the amount to record. The allowances associated with individual loans, pools of loans, and categories of loans should be accumulated to obtain the total allowance for loan losses.

Accounting Principles: Measurement and Disclosure

6.11 FASB Statement No. 5 is the primary authoritative standard on the accounting and reporting of loss contingencies, including loan losses.[22] 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.

6.12 FASB Statement No. 5 states that when a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset can range from probable to remote. FASB Statement No. 5 defines *probable* to mean that the future event or events are likely to occur. The conditions for accrual are not intended to be so rigid that they require virtual certainty before a loss is accrued. The conditions may be considered in relation to individual loans or groups of loans.

6.13 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 have been incurred at the statement-of-financial-condition date but are not identifiable on a specific loan-by-loan basis.

6.14 The allowance account is increased by charges to current-period operations when the account balance is deemed insufficient to provide for losses that have been incurred at the statement-of-financial-condition date. 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.

6.15 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.

6.16 Allowances on specifically identified doubtful or troubled loans collateralized by real estate should be based on the estimated net realizable

[22] In June 1992 the FASB issued an exposure draft of a proposed Statement, *Accounting by Creditors for Impairment of a Loan*, which would amend FASB Statement Nos. 5 and 15 and, when final, could significantly change the way credit unions account for the allowance related to impaired loans. A final Statement on loan impairment is expected by mid-1993.

value of the underlying collateral,[23] unless the criteria for in-substance foreclosure in Practice Bulletin No. 7, as amended by Practice Bulletin No. 10, 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[24] 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 should account for a troubled-debt restructuring in accordance with FASB Statement No. 15 and should continually assess the collectibility of the resulting receivable as required by FASB Statement No. 5.

6.17 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 in accordance with paragraph 36 of APB Opinion No. 20, *Accounting Changes.* Such a change frequently arises when a credit union that has in the past undergone only supervisory committee audits initially undergoes an audit in accordance with generally accepted auditing standards.

Financial Statement Presentation

6.18 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.

6.19 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

6.20 When auditing the allowance for loan losses, the auditor is concerned primarily with the valuation assertion embodied in the financial statements.

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[23] 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 has issued an exposure draft of a proposed Statement (see footnote 22) that would require the time value of money to be considered in determining the allowance. Readers should be alert for the issuance of final accounting standards by the FASB in this area.

[24] *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 auditor's objectives when evaluating the allowance are to obtain reasonable assurance that the allowance is adequate to cover the estimated amount of losses in the loan portfolio that have been incurred 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. The auditor achieves these objectives by reviewing management's estimates of the allowance and by considering available and relevant information regarding loan collectibility. The auditor is not responsible for calculating the amount of the allowance or ascertaining the collectibility of each specific loan in the credit union's portfolio.

Planning Considerations

6.21 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. Accordingly, auditors generally assess inherent risk related to the allowance as high. The process of auditing the allowance for loan losses involves several subjective aspects, and in accordance with SAS No. 22, the assigned audit staff should 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 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. In addition, 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.

6.22 The nature, timing, and extent of tests that the auditor applies to achieve the audit objectives are based on, among other things, the auditor's assessment of inherent risk and control risk. An important consideration in the auditor's assessment of inherent risk in determining the scope of tests of the allowance is the level of credit risk in the loan portfolio. Other risk factors relevant to the assessment include collateral risk, concentration risk, management risk, operations risk and fraud or insider-abuse risk (see paragraph 6.27 for a detailed discussion of these risks). In making a preliminary assessment of the risk inherent in a credit union's lending activities, 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 loans, 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

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

Internal Control Structure

6.24 A credit union's internal control structure related to loans (see chapter 5) and the allowance may reduce the likelihood of material misstatements of the allowance. Specific relevant aspects of that structure include—

a. Management's communication of the need for a proper allowance for loan losses. The control environment strongly influences the effectiveness of the systems of controls and affects the auditor's assessment of control risk. The control environment reflects the overall attitude, awareness, and action of the board of directors and management concerning the importance of control. The auditor should consider (1) the level of involvement and quality of leadership provided by the board of directors, supervisory committee, and senior management in evaluating the allowance, (2) the organizational structure, (3) the independence and effectiveness of the internal audit, the internal loan review functions, or both, (4) methods of assigning authority, (5) management control methods, (6) personnel policies and practices, and (7) external influences.

b. Accumulation of relevant, sufficient, and reliable data on which to base the allowance. Management reports summarizing loan activity, renewals, and delinquencies are vital to the timely identification of problem loans and, consequently, are critical to the loan review function. The 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 and the timing of chargeoffs.

c. Determination of the allowance by qualified personnel. To the extent possible, loan review should be conducted by credit union

personnel who are independent of the underwriting, supervision, and collections functions. The specific lines of reporting depend on the complexity of the credit union's organizational structure, but the loan reviewers should report to a level in the credit union that is independent of the lending process.

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 the work of 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.

6.25 *Credit Strategy.* 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.

6.26 The objectives of a sound credit strategy are generally to set goals for portfolio growth or contraction and to establish limits on specific loan concentrations. Further, 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.

6.27 *Credit Risk.* 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. For individual loans, credit risk pertains to the borrower's ability and willingness to pay; however, the auditor should also consider additional risks that are involved in the overall 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 credit risk in a loan portfolio is assessed. 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. In addition, guidance on the auditor's responsibility when a possible illegal act is detected is provided by SAS No. 54.

6.28 *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.

6.29 *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 and guarantor 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.

6.30 *Credit Monitoring.* The nature and extent of credit-monitoring procedures generally vary by loan type and amount. For 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 ninety days or more past due.

6.31 *Collection.* Loans identified as potential 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.

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

6.33 *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, *Communication of Internal Control Structure Related Matters Noted in an Audit*. 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 should preferably 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.

6.34 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

6.35 If the auditor intends to assess control risk at below the maximum in the allowance-for-loan-losses area, he or she 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.

6.36 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, including the consideration of the internal auditor's work, ordinarily cannot alone reduce audit risk to a level that eliminates the necessity for the auditor to test directly assertions related to the allowance for loan losses. 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.

Evaluating the Adequacy of the Allowance for Loan Losses

6.37 As discussed previously, 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.

6.38 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.

6.39 In addition to performing analytical procedures, the auditor often 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 that of 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 can often 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.

6.40 *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 communicate with, the examiner would ordinarily be a limitation on the scope of the audit sufficient to preclude an opinion. Additional sources for identifying 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.
- Loan documentation and compliance exception reports.

6.41 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.

6.42 Other matters to consider concerning potential problem loans include—

- 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.
- The amount of experience and turnover of loan officers.

6.43 Indicators of troubled loans include the following:

- Significant defaults, including missed payments of either principal or interest, exist under the terms of the loan agreement.
- 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," since 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.
- 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.
- Extensions, renewals, or other modifications have been granted without adequate support. In these situations, the loan balance is often increased by the amount of accrued interest receivable to make a delinquent loan appear current.

6.44 Certain of the 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 test work.

6.45 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.

6.46 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.*

6.47 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.

6.48 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 are also 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.

6.49 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.

6.50 In evaluating loans for collectibility, the auditor should avoid—

- *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.

6.51 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 evaluating the allowance rather than considering the loan-loss exposure only from a historical viewpoint. The auditor should also review subsequent events and transactions occurring after the statement-of-financial-condition date through the completion of fieldwork.

6.52 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 the estimated net realizable value of the underlying collateral. If the loan meets the criteria for in-substance foreclosure in Practice Bulletin No. 7, as amended by Practice Bulletin No. 10, the amount should be written down to fair value and classified as other real estate owned (see chapters 5 and 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.

6.53 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.

6.54 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 have been incurred at the statement-of-financial-condition date but are not identifiable on a specific loan-by-loan basis.

6.55 The auditor should consider whether management's calculation of the allowance for loan losses is within a range that is 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.

6.56 Credit unions should not base the justification of a lower allowance for loan losses on the maintenance of the regular reserve. Regulators have historically stated that the regular reserve has been established to cover loan losses. Although this may be true in a technical sense, the regular reserve constitutes an appropriation of undivided earnings and should not be considered in determining the adequacy of the allowance for loan losses.

6.57 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

6.58 During their examinations of credit unions, regulators assess whether the credit union's allowance is adequate, since failure to maintain an adequate allowance is considered an unsafe and unsound business practice. However, the amounts determined by management and the regulatory examiners may differ due to the subjectivity involved in estimating the amount of the allowance and the methods used in calculating the allowance.

6.59 For regulatory purposes, credit unions have historically used either the experience method or the adjustment method to calculate their allowance for loan losses. In July 1992, the NCUA issued Accounting Bulletin No. 92-1, which provides guidance to credit unions for establishing and maintaining the allowance for loan losses. The allowance required by Accounting Bulletin No. 92-1 is conceptually the same as the allowance that would be reported under GAAP. Although the application of the NCUA's methods may or may not result in substantially the same allowance as management's estimate for the allowance, management should report an allowance in the financial statements

prepared under GAAP that is adequate to cover all estimated losses incurred at the statement-of-financial-condition date in the loan portfolio.

6.60 In EITF 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, since 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.

Chapter 7

Mortgage-Banking Activities

Introduction

7.01 Growing numbers of credit unions are engaging in mortgage-banking activities. Such activities consist primarily of the origination or acquisition of loans for resale to secondary market investors and the subsequent servicing of 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 FHLMC, GNMA, DVA, and FNMA significantly enhance the marketability of loans. Such 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 have shifted their emphasis from merely holding loans to developing and supporting mortgage instruments that are highly liquid and attract broader interest in the secondary market.

7.02 Access to the secondary mortgage market can be an important source of liquidity for credit unions. Selling loans in the secondary market can affect the ability of credit unions to meet their liquidity needs by generating funds for additional loans and by earning income from servicing fees. To remain competitive, credit unions have developed increasingly rate-sensitive deposit bases. The resultant proliferation of variable-rate funding structures and their use to finance long-term, fixed-rate assets has resulted in significantly increased exposure to loss in rising interest rate environments. The ability to generate mortgage loans for resale provides credit unions with an alternative source of funds. In addition, access to the secondary market provides credit unions with opportunities to restructure their existing longer-term portfolios in response to changes in their funding structures.

7.03 When loans are originated for resale, the origination process includes not only finding an investor for the loans originated but also preparing loan documents that meet the investor's requirements. When loans are originated for resale to government agencies as well as to other private investors, compliance with specific standards governing documentation, appraisal, mortgage insurance, loan terms, and borrower qualifications is normally required. Investors typically review underlying documentation prior to consummation of the loan 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 have to be found or the loans may have to be transferred to the credit union's loan 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.

7.04 The extent to which loans are originated for resale differs among credit unions. Factors that influence the nature and extent of mortgage-banking activities in individual credit unions include liquidity, interest rate exposure, management policy, and capital considerations. Some credit unions may manage their interest rate risk positions by selling all fixed-rate loans they originate, while others may originate a variety of both fixed- and variable-rate loan products for resale.

Loan Servicing

7.05 When participations in loans are 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. Loan-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.

7.06 Serviced loans may be originated by the servicing credit union itself or by other financial institutions. When servicing mortgages for service agents such as GNMA, FNMA, or FHLMC, credit unions must meet certain minimum net-worth requirements. Inability to meet the requirements may result in termination of the service contracts.

7.07 Credit unions that service loans receive a servicing fee as compensation. Such fees are normally expressed as a percentage of the principal balance of the outstanding loans and are recognized over the life of the loans as payments are received. In addition to generating fee income, 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. Other intrinsic-value components of servicing rights include ancillary income, such as late-payment charges and prepayment charges.

Accounting Principles: Measurement and Disclosure

Loans Held for Sale

7.08 FASB Statement No. 65 provides guidance on accounting for mortgage loans and mortgage-backed securities held for sale and on accounting for loan sales transactions. FASB Statement No. 65 prescribes that mortgage loans and mortgage-backed securities held for sale should 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 amount by which the cost of such loans exceeds market value should be accounted for as a valuation allowance.

7.09 FASB Statement No. 65 also provides guidance on determining the market value of mortgage loans and mortgage-backed securities held for sale. The Statement prescribes that the market value of committed loans and uncommitted loans be determined separately as follows:

- Committed loans should be valued based on actual commitment prices. Such commitment prices should be adjusted as described in the Statement if they provide for servicing fee rates that differ materially from current servicing fee rates. 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.
- Uncommitted loans should be valued based on the market in which the credit union normally operates (for example, servicing retained or released):

  (1) Commitment prices, to the extent the commitments clearly represent market conditions at the balance sheet date

(2) Market prices and yields sought by the mortgage banking enterprise's normal market outlets

(3) Quoted GNMA security prices or other public market quotations for long-term mortgage loan rates

(4) FHLMC and FNMA current delivery prices

- Changes in the valuation allowance should be included in the determination of the net income of the period in which the change occurs.
- 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

7.10 The objectives of accounting for sales of loans are to recognize the economic gain or loss from the transaction in the period of sale and to avoid recognition of income or expenses 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).

7.11 Variable-rate loans are generally 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. Fixed-rate loans are generally sold at a discount or premium to provide a specified yield to the investor, and 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.

7.12 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 (for example, interest-only strips), and should reflect the risks associated with the asset. Prepayment estimates should be based on the prepayment experience for similar instruments. Prepayments of the underlying loans directly affect the asset or liability valuation and should be evaluated continually to ensure that amortization is appropriate. 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 value. 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.

7.13 FASB Technical Bulletin No. 87-3 provides additional guidance on accounting for mortgage-servicing fees and rights. The FASB's EITF has also reached consensuses 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 the issues associated with loan sale transactions, current FASB pronouncements should be consulted when a credit union's financial statements include loan sale transactions.

Sales of Loans With Recourse

7.14 Credit unions sometimes sell loans to government agencies or private investors on a with-recourse basis. Such transactions may be entered into to deliver loans into a particular investor's commitment program, to obtain better prices, or both. Because of the continuing risk of delinquency and foreclosure, managements of credit unions that enter into such transactions should carefully evaluate potential contingent liabilities with respect to such loans. Chapter 5 and FASB Statement No. 77 provide guidance on accounting for sales of loans with recourse.

Servicing Rights

7.15 Contractual rights to service loans represent significant assets for many credit unions. Internally originated servicing rights (those relating to loans originated by the credit union) are not reflected on a credit union's statement of financial condition. Purchased servicing rights, however, are recognized. Servicing rights have significant value and are readily marketable. Thus, a credit union's portfolio of servicing rights represents a potential source of earnings and capital.

7.16 Servicing rights may be purchased or sold either separately or as part of the purchase or sale of loans. Sales of servicing rights relating to loans previously sold may be recognized in income provided that conventional revenue-recognition principles permit doing so and that appropriate agencies have approved transfer of the servicing rights. Sales of servicing rights relating to loans that are retained should not be recognized in income at the time of sale. The proceeds from such sales should be accounted for in a manner similar to loan discounts and accreted into income using the interest method, with resulting gains and losses recognized as adjustments to the yield of the related loans.

Purchased Servicing Rights

7.17 Purchased servicing rights should be capitalized and amortized against future service fee income. 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. Since the actual revenue stream will usually differ from that estimated in valuing the rights purchased, it is extremely important that the recoverability of purchased servicing rights be evaluated periodically.

7.18 FASB Statement No. 65 and FASB Technical Bulletin No. 87-3 provide guidance on the accounting treatment of servicing rights acquired in a purchase of loans. 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 further guidance on valuing purchased servicing rights, implications of prepayments, and the impact on the carrying amount of purchased servicing rights of gains on the subsequent sale of underlying loans.

Sales of Servicing Rights

7.19 In general, three to six months elapse between entry into a contract to sell servicing rights and 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, difficulties in obtaining necessary agency approval, requirements to give advance notification of mortgagors, and other planning considerations. Issues relating to the transfer of risks and rewards between buyers and sellers of servicing rights may be complex. FASB EITF Consensus No. 89-5, *Sale of Mortgage Loan Servicing Rights,* indicates that sales 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.

7.20 In evaluating whether significant unresolved contingencies that would preclude recognition of a sale of servicing rights when the seller has received cash or an adequate cash down payment and acceptable notes or other consideration, and when the contractual title and the risks and rewards of ownership have passed, criteria such as the following should be considered:

- Whether the seller has received written approval from all applicable agencies.
- Whether the buyer is a currently approved seller-servicer, and is not at risk of losing approved status.
- Whether 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 should be eligible for transfer, and the seller's underwriting/documentation review and servicing procedures should be adequate to ensure transfer. In addition, due diligence procedures should have been completed by the buyer and the initial approval of transfer should 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, whether an adequate nonrefundable down payment necessary to demonstrate the buyer's commitment to pay the remaining sales price has been received, and whether the note receivable from the buyer provides full recourse to the buyer. Nonrecourse notes or notes with limited recourse (such as to the servicing) are not acceptable.

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 subservicing fee. Any benefits related to escrow deposits held by the seller during the temporary servicing period should accrue to the buyer.

7.21 Servicing rights may be purchased by brokers or investment bankers who intend to seek buyers for the rights. Although such purchases are 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. Thus, such transactions should generally be characterized as financing transactions. A sale has not occurred until an 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, 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

7.22 Historically, the DVA paid lenders 100 percent of the outstanding debt on defaulted loans that they guaranteed. In return, the lenders turned the borrowers' houses over to the DVA, which would dispose of them. The DVA 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 is 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 foreclosed houses 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. Credit unions may also 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.

7.23 With the increased risk of foreclosure losses (including unrecoverable interest advances; foreclosure costs such as attorney's 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. After foreclosure, such properties should be carried at the lower of (*a*) fair value less estimated costs to sell or (*b*) cost. Chapter 10 provides further guidance on accounting for foreclosed real estate, and chapter 6 provides guidance on accounting for the collectibility of real estate loans.

Financial Statement Presentation

7.24 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. The notes to the financial statements should disclose the following:

- 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)
- The amount of the servicing portfolio maintained by the credit union
- The amount capitalized during the period in connection with acquiring the right to service mortgage loans
- The method of amortizing the capitalized servicing rights
- The amount of amortization related to capitalized servicing rights for the period
- 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

7.25 Audit objectives and procedures for loan origination and underwriting are discussed in chapter 5. The objectives of auditing other mortgage-banking activities are to obtain reasonable assurance that—

- Loans held for sale exist and are the property of the credit union.
- Loans held for sale are valued, classified, described, and disclosed in the financial statements in accordance with generally accepted accounting principles.
- 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, recorded, and disclosed in accordance with generally accepted accounting principles.
- Deferred loan sale premiums or discounts and purchased servicing rights are presented 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

7.26 In developing an audit strategy for the mortgage-banking activities of a credit union, the auditor should obtain an understanding of the mortgage-banking activities in which the credit union is engaged. The auditor should inquire about how the mortgage-banking activities relate to management's objectives for managing interest rate risk and enhancing liquidity. In obtaining an understanding of the mortgage-banking activities in which the credit union is engaged, the auditor should consider 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 also should inquire about the reporting systems used by management to account for mortgage-banking activities, 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. Such information is usually needed to manage risks arising from mortgage-banking activities.

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

Internal Control Structure

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

7.29 *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

7.30 After obtaining an understanding of internal control structure policies and procedures related to mortgage banking activities, the auditor may conclude that the policies and procedures that have been placed in operation are likely to be effective and that audit efficiency can be improved by assessing control risk at below the maximum. Tests of controls that may be used to obtain evidence to support such an assessment include—

- Reviewing custodial account reconciliations and supporting documentation to ensure that all activity is processed and cleared currently.
- 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

7.31 The auditor should determine the nature, timing, and extent of substantive tests based on his or her assessment of inherent and control risks. The scope of audit procedures for mortgage-banking activities is also affected by regulatory matters and the need to provide special-purpose reports to investors. Substantive tests that the auditor should consider include—

- Selecting a sample of borrower remittances and testing allocation of payment amounts to income, principal, escrow, and service fee accounts.
- 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. 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 classified as investments for the foreseeable future or until maturity.
- 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, sale-versus-financing treatment, and so on, have been treated properly.
- Recalculating a sample of loan sale transactions to ensure proper calculation of weighted average rates and corresponding gains or losses.
- 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 testing the allowance for loan losses.

Chapter 8

Members' Share and Savings Accounts

Introduction

8.01 The principal source of funds for credit unions are members' share accounts and savings deposits. The members of a credit union are also its owners. The deposits of the owner-members are referred to as "share accounts" and the interest paid on the accounts is referred to as 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 deposits with credit unions. Some credit unions permit nonmembers to deposit funds subject to certain restrictions.

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

- *Demand Deposits*
  - *Regular shares* represent deposits that are normally available to the depositor-member without prior notice of intent to withdraw.
  - *Share draft accounts* (or checking accounts) represent deposits that may be withdrawn through the use of drafts (checks).

  Access to funds in both regular share and share draft accounts can often be accomplished through ATM transactions and preauthorized payment transactions. Deposits can often be made through direct deposit of payroll and other checks and through ATM transactions.

  - *Money market accounts* represent deposits on which interest is paid at a variable rate based on yields on securities traded in other specified financial markets. Such accounts frequently require a minimum balance and offer higher rates of interest than do other demand deposit accounts, and may have limits on the number of transfers or withdrawals permitted over specified periods.
- *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 members with a vehicle for retirement savings and to provide tax benefits for certain contributions to, and interest earned on, the account.

8.03 Within the foregoing categories, certain accounts may become inactive or dormant with the passage of time. Such accounts are classified as dormant at the discretion of the individual credit union or in accordance with state laws or regulations. 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

8.04 Disclosures that credit unions should make related to members' share and savings accounts include—

- 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 information is presented 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.
- The amount of 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.
- The aggregate amount of accounts over $100,000.
- The means by which interest rates are determined by the board of directors.
- The priority of other liabilities over shares in claims against the assets of the credit union.
- Restrictions on the payment of interest.

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

Financial Statement Presentation

8.05 Federal credit unions are required to report members' shares as equity for regulatory purposes. Generally accepted accounting principles require that all member deposit accounts of credit unions, including member shares, be reported as liabilities in the statement of financial condition. It must be unequivocal on the face of the statement of financial condition that deposit accounts are a liability. The statement of financial condition must either (*a*) present deposit accounts as the first item in the liabilities and equity section or (*b*) include deposit 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 is not 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 in the statement of financial condition. This is the same position that the FASB's EITF took in EITF Consensus No. 89-3, *Balance Sheet Presentation of Savings Accounts in Financial Statements of Credit Unions.*

8.06 FASB Statement No. 107 requires disclosure of the fair values of financial instruments including liabilities. Paragraphs 4.29 through 4.33 describe the required disclosures.

Audit Objectives and Procedures

Audit Objectives

8.07 The objectives of auditing members' share and savings deposits are to obtain reasonable assurance that (*a*) members' shares and savings accounts include all such liabilities of the credit union and reflect all transactions for the period and (*b*) the accounts are valued, classified, described, and disclosed in accordance with generally accepted accounting principles.

Internal Control Structure

8.08 An effective internal control structure should include policies and procedures 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.

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

- The detail subsidiary ledgers are reconciled to the general ledger on a periodic basis. This includes interest accruals as well as the deposit principal balances.
- Appropriate individuals—typically, officers or supervisory employees—are assigned responsibility for approving unposted holdover items, overdrafts, return items, and activity on dormant accounts.
- Files, ledger cards, canceled checks, deposit tickets, and signature cards are adequately protected. These items are typically maintained in fireproof containers, and access is restricted to appropriate personnel. In addition, the supplies (typically prenumbered) of unissued certificates of deposit are maintained under dual control.
- Duties related to deposits are adequately segregated. 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 of account activity are mailed to the depositor on a regular basis. Returned statements are properly controlled, and adequate follow-up is performed.
- Appropriate controls exist over wire transfers and the propriety of the subsidiary ledgers (see paragraphs 3.11 and 3.12).
- An appropriate individual is assigned to review activity in employee accounts for unusual or unauthorized transactions.

Tests of Controls

8.10 Specific procedures that the auditor should consider performing to test the operating effectiveness of internal control structure policies and procedures related to members' deposits include—

- Observing, or otherwise obtaining evidence of, controls over origination of and access to signature cards.
- Observing, or otherwise obtaining evidence of, controls over origination of and access to mailing address files.

- Observing, or otherwise obtaining evidence of, controls over mail receipts.
- Testing compliance with policies regarding early-withdrawal-penalty interest recognition.
- Reviewing reconciliations to determine that they are performed periodically and are reviewed and approved by an appropriate individual and that reconciling items are cleared in a timely manner.
- Observing, or otherwise obtaining evidence, that there is adequate segregation of duties.
- Obtaining evidence that an appropriate individual reviews activity in employee accounts.

Substantive Tests

8.11 The auditing procedures typically employed to audit members' share and savings deposit accounts are primarily substantive in nature because of the requirements of the NCUA (discussed below) and other regulators. The auditor may decide to perform certain of these audit procedures at an interim date. Before doing so, however, the auditor should assess whether the incremental audit risk can be adequately controlled. SAS No. 45, *Omnibus Statement on Auditing Standards—1983,* "Substantive Tests Prior to the Balance-Sheet Date," paragraphs 5 through 7, provides guidance in making the assessment.

8.12 *Confirmation.* SAS No. 67 provides guidance about the confirmation process in audits performed in accordance with GAAS. Confirmation of deposit account balances provides evidence of existence and accuracy. The extent and method of selection and evaluation are left to the auditor's judgment. Auditors of financial statements of credit unions may use either positive or negative forms of confirmation requests to confirm members' share and savings deposits. However, SAS No. 67 places certain limitations on circumstances in which negative confirmation requests can be used, which are described in chapter 5.

8.13 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. The rules set forth by the NCUA require that the verification be made using either of the following methods: (*a*) a controlled verification of 100 percent of members' share and loan accounts or (*b*) 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.

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

8.15 SAS No. 39 provides that either statistical or nonstatistical sampling, when properly applied, can provide sufficient evidential matter in performing audits in accordance with GAAS. Consequently, in auditing the financial statements of federally insured credit unions in accordance with GAAS, auditors are not prohibited from confirming accounts using nonstatistical sampling methods; however, because coordination of the confirmation process for GAAS and supervisory committee audit purposes is normally desired by the supervisory committee, statistical sampling methods that

comply with NCUA rules and regulations are frequently used in confirming the accounts. Regardless of which type of audit sampling technique (statistical or nonstatistical) is used, the population from which the sample of balances is selected for confirmation should include both dormant accounts and accounts closed during the audit period. If a nonstatistical sampling method is used, the auditor may consider stratifying the population in order to cover a greater number of large and unusual accounts.

8.16 Confirmation requests generally should be prepared as of the date selected for performing other auditing procedures for the corresponding subsidiary ledgers. The auditor also should ascertain that the account information to be confirmed and tested actually represents the data on which the financial statement amounts are based. 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 or differences between the general ledger and the subsidiary ledger that may be of particular concern are returned items, adjustment items, holdovers in departments, overdrafts, and service charges. The auditor should test the subsequent disposition of reconciling items.

8.17 Some members may have instructed the credit union that their accounts be treated on a no-mail basis. When such accounts are selected for confirmation, the auditor should be able to examine a written request from the member requesting the no-mail status and should use alternative procedures to obtain adequate evidence regarding the existence and accuracy of the account balance. 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. However, the omission of alternative procedures may be acceptable (*a*) when the auditor has not identified unusual qualitative factors or systematic characteristics related to the nonresponses, such as that all nonresponses pertain to year-end transactions, and (*b*) when testing for overstatement of amounts, the nonresponses in the aggregate, when projected as 100 percent misstatements to the population and added to the sum of all other unadjusted differences, would not affect the auditor's decision about whether the financial statements are materially misstated. If the auditor concludes that alternative procedures are necessary but are not practicable, the auditor should consider whether a scope limitation exists.

8.18 *Tests of Interest Payable and Interest Expense.* Accrued interest payable, interest expense, and service charge income should be tested in connection with the audit of members' share and savings accounts. Specific procedures the auditor should consider performing related to interest include reconciling subsidiary records with the general ledger controls, recalculating interest paid and accrued interest payable, and testing interest expense for a specified period. Analytical procedures that auditors may use to test interest include comparing interest expense for the period under audit with the average balance of the respective interest-bearing savings accounts and comparing the resulting yields with interest rates in effect during the period. Service charge income should be tested to determine that the fees charged are reasonable and are in accordance with the credit union's policy.

Chapter 9

Borrowed Funds and Other Obligations

Introduction

9.01 Like other business enterprises, credit unions sometimes borrow money to meet their short-term operational needs. Some credit unions obtain lines of credit from other financial institutions. The amounts that credit unions may borrow are, in most cases, limited by regulatory authorities to a percentage of their members' shares and equity.

9.02 The following are types of borrowings available to credit unions:

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

Certificates of Indebtedness

9.03 Certificates of indebtedness are a special form of time deposit and generally bear interest at rates higher than those paid on savings accounts. Certificates of indebtedness are generally uninsured. Unlike savings accounts, certificates of indebtedness may be offered ("sold") to nonmembers as well as to members of the credit union, although the majority of such certificates are sold to members. The higher interest rates are sometimes limited to certificates held to maturity. Some credit unions impose an early-withdrawal penalty for certificates not held to maturity.

Mortgages Payable

9.04 Credit unions sometimes finance expansion programs by using traditional mortgages secured by the real estate they own.

Capital Lease Obligations

9.05 Capital lease obligations result from financing transactions that are structured as leases that transfer substantially all the benefits and risks inherent in the ownership of 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

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

Letters of Credit

9.07 Letters of credit (often referred to as "standby credits") are versatile instruments commonly used as a type of guarantee. They are often used in lieu of suretyship contracts and arrangements that call for some guarantee of performance or payment.

Reverse-Repurchase Agreements

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

Accounting Principles: Measurement and Disclosure

9.09 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 FASB Statement No. 107 requires disclosure of the fair value of financial instruments, including those representing liabilities. Paragraphs 4.29 through 4.33 describe the required disclosures.

9.11 FASB Statement No. 13 requires disclosure of information relating to operating leases having noncancelable lease terms in excess of one year. Information required to be disclosed includes minimum future rent payments, minimum sublease income, and a schedule of total rental expense.

9.12 Depending on the nature of the transaction, 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 those reverse repos that should be accounted for as sales and subsequent repurchases of securities and those that should be accounted for as financing arrangements is the degree of control over the future economic benefits relating to the securities sold and reacquired by the seller-borrower. If the securities sold are identical to the securities repurchased, 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, such transactions are generally accounted for as financing arrangements.

9.13 In accounting for reverse repos as financing arrangements, a liability for the amount of the proceeds should be recorded at the time of sale. 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. The difference between the selling price and the repurchase price should be accounted for as interest expense and should be recognized over the term of the agreement. Interest expense recognized under these agreements should not be offset against the interest income on the securities sold; rather, the interest should be reported on a gross basis.

9.14 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. Information disclosed as of 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.[25] 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.[26] 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. Information disclosed for the period should include—
- — 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.

Audit Objectives and Procedures

Audit Objectives

9.15 The objectives of auditing borrowed funds and other obligations are to obtain reasonable assurance that—

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[25] *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.

[26] *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's loss exposure if it lacks control over the collateral in a repurchase transaction is different from its loss exposure 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.

- All obligations for borrowed funds have been valued, classified, described, and disclosed in the financial statements in accordance with generally accepted accounting principles.
- All off-balance-sheet obligations (such as operating leases and guarantees) have been identified and considered.
- 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 have been properly authorized and are obligations of the credit union.

Planning Considerations

9.16 The auditor should consider factors that influence inherent risk related to borrowings. Such factors might include regulatory considerations, the existence of restrictive covenants, and the existence and adequacy of collateral, if applicable.

Internal Control Structure

9.17 Examples of typical 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 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.
- Procedures are periodically performed to ensure that interest expense is properly accrued and recorded.

Tests of Controls

9.18 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

9.19 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.
- The existence of and compliance with debt covenants.

9.20 *Confirmation.* The auditor should consider confirming pertinent information regarding borrowings with the credit grantor. Information that the auditor should consider confirming includes all terms, unpaid balance, accrued interest payable, principal, and interest payments made during the year, as well as collateral description. If collateral is not under the control of the credit union and is held by a trustee, the auditor should consider confirming its existence, completeness, and valuation with the respective trustee.

9.21 *Analytical Procedures.* Analytical procedures relating to other borrowings that the auditor should consider performing include the following:

- Comparing 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
- Evaluating 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)

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

9.23 *Other Procedures.* Other audit procedures related to other borrowings include—

- Reading minutes of meetings of the board of directors and testing whether financing transactions, including such debt equivalents as capitalized leases, have been properly authorized.
- Obtaining a detailed supporting schedule with prior-year balances and current-year balances; agreeing the prior-year balance to prior-year working papers and the current-year balance to the general ledger; reviewing activity for reasonableness.
- Comparing the cost of funds during the period with the expected cost of funds based on terms of respective agreements and previous experience; investigating any significant discrepancies.
- Reviewing debt covenants and testing whether the credit union has complied with such covenants; determining whether disclosures are appropriate.
- Examining lease agreements; identifying those that should be capitalized and determining whether they were recorded using effective rates of interest in conformity with generally accepted accounting principles.
- Confirming and verifying line of credit agreements and determining whether appropriate disclosures have been made.
- Examining canceled notes for borrowings that have been paid in full.

Chapter 10

Other Assets and Other Liabilities

Introduction

10.01 Other assets of a credit union frequently include the following:

- 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

10.02 Other liabilities of a credit union frequently include the following:

- 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

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

10.04 Section 107(4) of the Federal Credit Union Act (as well as many state statutes), allows credit unions to purchase, hold, and dispose of only that property which 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.

10.05 Property and equipment accounts should include all costs related to the acquisition of the property and equipment, including transportation and installation costs. If a credit union constructs property, cost should include all direct construction costs together with architect's 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).

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

10.07 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, either 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.

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

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

10.10 *Foreclosed Assets.* These include all assets received in satisfaction of receivables in troubled-debt restructurings. Foreclosed assets may include real property; personal property; equity interests in corporations, partnerships, and joint ventures; and beneficial interests in trusts. Foreclosed assets also include in-substance foreclosed assets, which represent loans that are treated as if the underlying collateral had been foreclosed even though formal foreclosure or repossession proceedings are not involved.[27]

10.11 SOP 92-3 provides guidance on accounting for the balance sheet treatment of foreclosed assets. At the time of foreclosure or in-substance foreclosure[28] the foreclosed or in-substance foreclosed asset should be recorded at its fair value.[29] Under the SOP there is a presumption that foreclosed assets are held for sale and not for the production of income unless that presumption can be rebutted by a preponderance of the evidence. It is unlikely that credit unions would rebut the presumption for real estate assets, because regulators typically prohibit them from holding real estate that is not necessary or incidental to their operations.

10.12 After foreclosure, foreclosed assets held for sale and in-substance foreclosed assets should be carried at the lower of (*a*) fair value less estimated costs to sell or (*b*) cost. Any deficiencies should be charged to income and a valuation allowance recognized. If the fair value of the asset less estimated costs to sell subsequently increases and is greater than the carrying amount of the asset, the valuation allowance should be reduced, but not below zero. Increases or decreases in the valuation allowance should be charged or credited to income. The amount of any senior debt to which a foreclosed asset is subject should be reported as a liability at the time of foreclosure and not deducted from the carrying amount of the asset.

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[27] The AICPA Accounting Standards Executive Committee is currently working on a statement of position on accounting for the results of operations of foreclosed assets held for sale. The issues being considered are whether revenues and expenses related to foreclosed assets held for sale should be charged or credited to the asset or to income and whether depreciation should be recognized on foreclosed assets.

[28] Practice Bulletin No. 7, as amended by Practice Bulletin No. 10, discusses criteria for determining whether a loan has been in-substance foreclosed. See chapter 5 for a discussion of that issue. If the criteria are met, the reporting of the asset should change from that of a loan receivable to that of a foreclosed asset.

[29] See footnote 15.

10.13 Sales of foreclosed real estate assets should be accounted for in accordance with FASB Statement No. 66, *Accounting for Sales of Real Estate.* FASB Statement No. 66 sets forth criteria for determining whether sales of real estate have occurred and, if so, which of the six primary methods of profit recognition (full accrual, installment, percentage-of-completion, reduced profit, deposit, and cost recovery) is appropriate under the circumstances.

10.14 FASB Statement No. 98, *Accounting for Leases,* provides guidance on accounting for sale-leaseback transactions. Relevant guidance is also provided by the FASB's EITF consensuses on various real estate sales matters, such as Issue No. 84-17, *Profit Recognition on Sales of Real Estate with Graduated Payment Mortgages or Insured Mortgages* and Issue No. 84-37, *Sale-Leaseback Transaction with Repurchase Option.*

10.15 *Acquisition, Development, and Construction Loans.* In these loans, credit unions that lend money to acquire, develop, or construct property take on virtually the same risks and potential rewards as the owners or joint venturers who borrow the money. Such arrangements tend to expose credit unions to greater risk than normal lending arrangements and, as such, require careful analysis by auditors. 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.

10.16 *National Credit Union Share Insurance Fund Deposit.* Federally insured credit unions are required to maintain on deposit with the NCUSIF an amount equal to 1 percent of their total insured shares. The amount on deposit is adjusted periodically for changes in the amount of a credit union's insured shares. For example, 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 is also 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.

10.17 Amounts deposited with the NCUSIF should be accounted for and reported as assets as long as such amounts are fully refundable. The refundability of NCUSIF deposits should be evaluated periodically. When the refundability of a deposit is evaluated, the financial condition of both the credit union and of the NCUSIF should be considered. Deposits may be returned to solvent credit unions for a number of reasons, including termination of insurance coverage, conversion to insurance coverage from another source, or transfer of operations of the insurance fund from the NCUA Board. Insolvent or bankrupt credit unions are not entitled to a return of their deposits. To the extent that NCUSIF deposits are not refundable, they should be charged to expense in the period in which the deposits are made or the assets become impaired.

10.18 In years in which 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. Such distributions may be in the form of a waiver of insurance premiums, premium rebates, or cash payments. Payments received in connection with that reduction in the equity of the NCUSIF should be reported as current-period income in the period in which it is determined that a distribution will be made.

10.19 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 in which 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 has been industry practice to net imputed earnings on the insurance deposits against imputed premium expense rather than present them as gross amounts on the statement of income. In years in which the insurance premiums are not waived by the NCUA Board, the premiums should be expensed in the period to which they relate. To the extent that the NCUA Board assesses premiums to cover prior operating losses of the insurance fund or to increase the fund balance to "normal operating levels," credit unions should expense those premiums when assessed.

10.20 *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 amounts of investments in or loans to CUSOs are governed by federal and state regulations.

10.21 In accordance with APB Opinion No. 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 the operating and financial policies of the CUSO. Majority-owned subsidiaries should be included in the consolidated financial statements of the credit union in accordance with FASB Statement No. 94 and ARB No. 51.

10.22 *Accrued Interest Receivable.* Interest receivable on loans and debt securities held as 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.

10.23 *Contributed Assets.* Credit unions occasionally receive donations of assets of material value. Such donations should be recognized as revenue in the period received and should be debited 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, significant uncertainty about the existence of value may indicate that an item received is not an asset and should not be recognized.

10.24 *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

10.25 *Accounts Payable.* Accounts payable in the financial statements of a credit union typically relate to routine operating expenses similar to those of other business enterprises. Accounts payable may also include liabilities for unclaimed or dormant share accounts and unpresented checks. State escheat laws sometimes require that these amounts be remitted to the state after a specified period of time.

10.26 *Accrued Interest Payable.* Accrued interest payable is often a significant liability in the financial statements of credit unions 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.

10.27 *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 also be accrued and reported.

10.28 *Suspense Accounts.* Suspense accounts frequently include unposted payroll deductions, unposted share drafts, or other unapplied items such as automated-teller-machine (ATM), electronic-funds-transfer (EFT), or automated-clearinghouse (ACH) transactions. Although recorded as liabilities in the general ledger, these accounts sometimes have debit balances. Items in suspense accounts should be reclassified to the appropriate accounts if the effect on statement-of-financial-condition amounts would be material.

10.29 *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

10.30 *Other Assets.* The objectives of auditing other assets are to obtain reasonable assurance that—

- The assets exist and are owned by the entity.
- The assets are presented in the financial statements in accordance with generally accepted accounting principles.
- The assets are properly classified in the financial statements, and related disclosures are adequate.

10.31 *Other Liabilities.* The primary objectives of auditing other liabilities are to obtain reasonable assurance that—

- The liabilities represent authorized obligations of the credit union.
- 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, and the related disclosures are adequate.

Planning Considerations

10.32 *Other Assets.* The other assets of many credit unions are relatively insignificant when compared with total assets. However, 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 the client personnel assigned responsibility for the other asset area.

10.33 *Other Liabilities.* The other liabilities of many credit unions are relatively insignificant when compared with total liabilities. However, 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 new services have been instituted, including selling consignments or offering share drafts.
- A significant increase in mortgage loans with corresponding escrow accounts.

Internal Control Structure

10.34 Typical internal control structure policies and procedures relating to the other assets and other liabilities areas include (*a*) maintenance of adequate subsidiary ledgers, which should be periodically reconciled to the general ledger, and (*b*) established procedures for the audit or review of financial statements of subsidiaries to determine the propriety of recorded balances as of the financial statement date.

10.35 In addition, 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

10.36 *Property and Equipment.* Substantive audit procedures relating to property and equipment that the auditor should consider performing 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.

10.37 *Foreclosed Assets.* Substantive audit procedures relating to foreclosed assets that the auditor should consider performing include—

- Auditing management's estimate of the fair value of the assets. (SAS No. 57 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 generally accepted auditing standards.)

- 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.
- Reviewing the financial statement classification of foreclosed assets.

10.38 *Use of the Work of Real Estate Appraisers.* The AICPA *Guide for the Use of Real Estate Appraisal Information* and SAS No. 11 provide guidance to auditors on using the work of real estate appraisers. Appraisals are the products of work by people trained in appraisal principles and techniques. Appraisals 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 auditor should understand and consider the approaches and assumptions used in determining 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 the projects are 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.

10.39 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 that, in estimating value, there are inherent subjective determinations 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 who is 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.*

10.40 *Other Assets.* Substantive audit procedures relating to other assets that the auditor should consider performing 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.
- Confirming recorded amounts.

- Testing calculations of amortization of prepaid assets.

10.41 *Other Liabilities.* Substantive audit procedures relating to interest payable, accrued expenses, and other liability amounts that the auditor should consider performing include—

- Tracing recorded amounts to supporting documentation.
- Agreeing rates used in the calculation of recorded amounts of interest payable to board of directors' authorization.
- Testing individual calculations of accrued interest (dividends).
- Tracing recorded amounts to subsequent cash disbursements.
- Investigating items in suspense accounts. If material, these items should 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.
- Confirming recorded amounts.
- Testing the calculation of the amounts of other recorded accruals.
- Performing a search for unrecorded liabilities.

Chapter 11

Equity

Introduction

11.01 Credit unions operate under a cooperative form of ownership. Members, in effect, "own" the credit union, although their interests in the credit union (that is, their 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

11.02 Undivided earnings represent unappropriated accumulated earnings or losses of the credit union since its inception. The accounting treatment of transactions in undivided earnings of a credit union is similar to that of transactions in retained earnings of corporate enterprises. The most common transaction in undivided earnings is the increase or decrease to close net income or loss at the end of each accounting period. These closing transactions, unlike those of most other enterprises, often occur on a quarterly basis. The undivided earnings may also be increased or decreased as a result of transfers to or from appropriated accounts such as the regular reserve.

Regular Reserve (Statutory Reserve)

11.03 The Federal Credit Union Act and certain states require that a regular (or statutory) reserve be established and maintained to provide an equity base for credit unions. The regular (or statutory) reserve account represents that required appropriation of equity.

11.04 The regular (or statutory) reserve is established through a charge to undivided earnings and a credit to the reserve account. For federal credit unions, the amount required to be transferred is defined in section 1762 of the Federal Credit Union Act and further addressed in section 700.1 of the NCUA *Rules and Regulations.* Those regulations require that a designated percentage of gross income be transferred at the end of each accounting period. The percentage is determined on the basis of the relationship of irrevocable reserves (which, for transfer-calculation purposes, includes the regular reserve, the allowance for loan losses, and the allowance for investment losses, reduced by the balance in the provision for loan losses account) to total risk assets.[30] That relationship is stated as a percentage which 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 amount required by the regulations.

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[30] 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.

11.05 Certain states have adopted similar regulations that apply to state-chartered credit unions. The statutes for each state should be consulted for applicable requirements.

11.06 The regular reserve should not be viewed as a substitute for or supplement to the allowance for loan losses. 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

11.07 The board of directors of a credit union may restrict or appropriate portions of undivided earnings for specific purposes in accordance with paragraph 15 of FASB Statement No. 5. Examples include appropriations for loss contingencies and for major expenditures. The amount of such appropriations is normally transferred from undivided earnings, pending resolution of its purpose. Amounts appropriated may be returned to undivided earnings when they are no longer deemed necessary.

11.08 In accordance with FASB Statement No. 12, credit unions are required to record a valuation allowance to reflect unrealized losses resulting from temporary declines in the values of investments in marketable equity securities held for investment or for sale.[31] Such allowances are the offset of the contra asset established to write down temporary declines of investments to their realizable value. Declines in investments that are other than temporary should be charged directly to operations.

Financial Statement Presentation

11.09 Retained earnings is generally shown as a single line item in the statement of financial condition. The components of retained earnings 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 appropriations and other restrictions of retained earnings should be disclosed.

Audit Objectives and Procedures

Audit Objectives

11.10 The objectives of auditing equity are to obtain reasonable assurance that—

- Balances are presented in accordance with generally accepted accounting principles.
- Disclosures of appropriations and restrictions of retained earnings are adequate.
- Balances are reported at proper amounts in the financial statements.
- Appropriations of retained earnings have been properly authorized.

Auditing Procedures

11.11 Equity accounts are typically tested using a substantive approach.

11.12 The auditor should be satisfied that regular reserve transfers have been made in accordance with regulatory requirements. To gain such satisfaction, the auditor should be familiar with the reserve requirements of the applicable federal and state laws and regulations. Other entries, including direct charges and credits in accordance with regulatory requirements, should

[31] See footnote 2.

be tested for propriety. Other appropriations of retained earnings should be traced to authorization by the board of directors.

11.13 In the event of reserve or undivided earning deficiencies, the credit union may be limited in such matters as payment of dividends (interest) 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. (See chapter 2 for a discussion of going-concern considerations.)

Chapter 12

Computer Processing

Introduction

12.01 Many 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.

12.02 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.

12.03 As credit unions venture into other services, additional computer-processing applications are usually introduced. Such services may include (*a*) access to automated teller machines, (*b*) processing credit card transactions, (*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.

12.04 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 onto 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 may be the least costly method used by credit unions to obtain computer-processing services. It requires a smaller in-house commitment in terms of dedication of capital, physical requirements, and personnel resources. 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 primarily to processing transactions for credit unions rather than to serving many types of clients with various product lines. Often, 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* generally involve ownership by a credit union of its own hardware and software and involve 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 used primarily by 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. Today, 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

12.05 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

12.06 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.*

12.07 *Service Bureaus—Third-Party Reviews.* When planning and performing the audit of a credit union that uses a service organization such as a service bureau or CUSO to process its transactions, the auditor should consider the guidance provided by SAS No. 70.

Reference Materials

12.08 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 Guide *Consideration of the Internal Control Structure in a Financial Statement Audit*

Other organizations have also 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

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

Accounting Principles: Measurement and Disclosure

13.02 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*

13.03 APB Opinion No. 16 applies to business combinations that involve credit unions. The purchase method and the pooling of interests 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 Opinion 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 credit unions 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 Opinion No. 16 for a pooling of interests. In general, the credit union's management must evaluate all of the salient facts underlying a business combination to determine the propriety of the accounting method to be applied.

13.04 In transactions accounted for using the purchase method, goodwill may arise from the value of liabilities assumed, 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 establishes authoritative standards for 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.

13.05 APB Opinion No. 17 requires the amortization of goodwill recorded as the result of a business combination over the periods expected to be benefited. The period of amortization, however, should not exceed forty years. APB Opinion No. 17 also requires periodic evaluation of the continuing appropriateness of the amortization period. A forty-year amortization period for goodwill (other than the portion accounted for in accordance with FASB Statement No. 72) arising from the acquisition of a credit union is often considered excessive in the current economic environment.

13.06 The NCUA does not encourage the recognition of goodwill in business combinations, but recognizes that GAAP requires the recognition of goodwill under certain circumstances.

NCUSIF-Assisted Acquisition of Credit Unions

13.07 FASB EITF Consensus No. 88-19 addresses situations in which savings institutions are acquired pursuant to an assistance 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.)

13.08 Under such an agreement, an acquirer of a credit union 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 such agreements 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.

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

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. To facilitate that assessment, the amount of regulatory assistance should be disclosed.

13.11 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 should 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 should be considered as additional interest in determining the fair value of the interest-bearing assets acquired. Goodwill should be reduced for any assistance that was received subsequent to the date of the acquisition and that had not been considered because its receipt was not probable or its amount was not reasonably estimable at the date of acquisition.

Audit Objectives and Procedures

Audit Objectives

13.12 The objectives of auditing business combinations are to obtain reasonable assurance that—

- Such transactions are accounted for in accordance with generally accepted accounting principles.
- The fair values assigned to the assets and liabilities of the acquired credit union in a purchase accounting transaction are appropriate.
- Goodwill arising from a purchase transaction is amortized over an appropriate period of time.
- NCUSIF assistance received to facilitate the purchase is accounted for in accordance with generally accepted accounting principles.

Internal Control Structure

13.13 Typical internal control structure policies and procedures relating to business combinations include the following: (*a*) accounting entries made to record the transaction initially and those required in subsequent years are reviewed by supervisory personnel to ensure accuracy, and (*b*) subsequent to acquisition, the assumptions used in assigning values to assets and liabilities are reviewed by management for continuing validity.

Substantive Tests

13.14 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 period during which they occur.

13.15 In auditing business combinations accounted for using the purchase method, the auditor should examine documentation supporting fair values assigned to the acquired credit union's assets and liabilities. Significant asset and liability classifications such as office premises and equipment, other real estate, the loan portfolio, the fair value of certificates of deposit, and core deposit values can be supported by independent appraisals. 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 requesting the credit union's management to engage appraisers to determine the propriety of any significant assigned carrying values that are unsupported by independent appraisals.

13.16 The guidance in SAS No. 57 may also be useful to auditors in auditing fair values of assets and liabilities used in accounting for business combinations. In evaluating the reasonableness of estimates of such fair values, the auditor should consider whether, in developing their estimates of fair values, management has given appropriate consideration to credit risk, loan prepayment factors, and the interest rate assigned in relation to current market conditions.

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 identifiable and 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

14.01 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

14.02 FASB Statement No. 95 sets forth two methods of reporting cash flows from operating activities: the direct method and the indirect method. The Statement encourages, but does not require, the use of the direct method. 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.

14.03 In contrast, a statement of cash flows prepared using the indirect method reports the net cash flow from operating activities by adjusting the 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).

14.04 FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*, amends FASB Statement No. 95 to provide, among other things, that cash receipts and cash payments that result from purchases and sales of securities should be classified as operating cash flows if the securities are carried at market value as assets held for trading purposes. Similarly, cash receipts and cash payments that result from loans originated or purchased specifically for resale should 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 in using the direct method, the gross cash receipts and cash payments from these sources should be reported separately 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 should be reported in reconciling net income to the net cash flow from operating activities.

Investing and Financing Cash Flows

14.05 Cash flows from investing and financing activities should 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 generally 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

14.06 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

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.

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 decrease in other deposit accounts	Net increase 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

14.07 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,* amends FASB Statement No. 95 to permit financial institutions, including credit unions, 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. Credit unions should consider reporting gross cash receipts and cash payments for loans if doing so provides more meaningful information to financial statement users. FASB Statement No. 104 also provides that the classification of cash flows from forward contracts, futures contracts, options contracts, or swap contracts that are accounted for as hedges should be consistent 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

14.08 Investing and financing activities that are partially or fully noncash transactions should 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 credit unions include—

- Origination of mortgage loans to finance sales of foreclosed real estate.
- Acquisition of real estate through foreclosure of the related mortgage loans.
- 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*

14.09 The statement of cash flows displays the net change during the period in cash and cash equivalents. Cash and 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. In general, only investments with original maturities of three months or less qualify under this definition. 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

Reporting Considerations

Introduction

15.01 In this chapter 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, are discussed.

Reports on Audited Financial Statements

Standard Independent Auditor's Report

15.02 When reporting on the financial statements of a credit union, the auditor should follow the provisions of SAS No. 58. 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 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.

[*Signature*]

[*City*]

[*Date*]

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

15.03 Section 701.13 of the NCUA *Rules and Regulations* requires certain federal credit unions to have their financial statements audited by an indepen-

dent CPA. Some state regulatory agencies also require independent audits of the financial statements 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. SAS No. 62 recognizes bases of accounting that reporting entities use to comply with the requirements or financial reporting provisions of governmental regulatory agencies to whose jurisdiction they are subject as comprehensive bases of accounting other than generally accepted accounting principles, and provides guidance on reporting on OCBOA financial statements.

15.04 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, which requires federal credit unions to report members' shares as equity for regulatory purposes.

Independent Auditor's Report

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

15.05 As discussed in paragraph 8.05, generally accepted accounting principles require that members' shares be reported as liabilities in the statement of financial condition. Some credit unions, however, report members' shares as equity. Still other credit unions use an unclassified presentation and report all liabilities and equity together under one subheading with

members' shares shown as the last items before undivided earnings. If members' shares are reported as such, or in any other manner in which it is not unequivocal that members' shares are liabilities, and the shares are material to the financial statements, the auditor should express a qualified opinion or, in certain cases, an adverse opinion on the financial statements unless the financial statements are prepared using a comprehensive basis of accounting other than GAAP (see paragraphs 15.03 and 15.04). An illustration of a report modified in those circumstances follows.

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.

Reports on Supervisory Committee Audits

15.06 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.

15.07 Independent auditors' reports 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 42 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.

15.08 Independent auditors' reports on the performance of agreed-upon procedures in connection with a supervisory committee audit should be prepared in accordance 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—

- Indicate the specified elements, accounts, or items to which the agreed-upon procedures were applied.
- Indicate the intended distribution of the report.
- Enumerate the procedures performed.
- State the accountant's findings.

- Disclaim an opinion with respect to the specified elements, accounts, or items.
- 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.[32]

SAS No. 35 also states that if the accountant has no adjustments to propose to the specified elements, accounts, or items, the accountant may include a comment to that effect in his or her 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." The accountant may also wish to indicate that had he or she performed additional procedures with respect to the specified elements, accounts, or items or had he or she performed an audit of the financial statements in accordance with generally accepted auditing standards, (other) matters might have come to the accountant's attention that would have been reported.

15.09 As mentioned earlier, some regulatory agencies require that supervisory committee audit reports include financial statements or other data. In such instances, the supervisory committee usually includes the auditor's report on the application of agreed-upon procedures and the unaudited financial statements or data in its report to the regulatory agency.

15.10 An independent accountant may be requested to perform specific procedures in conjunction with 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 1, which states that 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. That provision, however, would not preclude the independent accountant 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 report on the application of agreed-upon procedures performed in connection with a supervisory committee audit.

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

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 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 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 with 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.

Communication of Internal Control Structure Related Matters

15.12 The independent auditor may become aware of reportable conditions in the internal control structure during the performance of the audit. SAS No. 60 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.

15.13 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.

Appendix A

Illustrative Credit Union Financial Statements

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.

The illustrative notes to the financial statements include disclosures that are generally required and some that are encouraged but not 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.

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 Federal Credit Union receives a normal servicing fee on all loans serviced for others, therefore, no excess servicing fees are reported in the financial statements.
- Sample CUSO has no taxable income and no income tax provision or deferred taxes.
- 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	$ 749	$ 689
Trading-account securities, at market value (note 2)	93	81
Investment securities (note 3)	43,022	26,720
Mortgage-backed securities (note 3)	1,322	1,291
Loans held for sale, net of unrealized loss of $58 in 19X2 and $73 in 19X1 (note 9)	10,918	11,322
Loans receivable, net of allowance for loan losses (note 4)	53,699	58,951
Accrued interest receivable	848	518
Other real estate owned, net of allowance for losses (note 5)	79	51
Property and equipment (note 6)	2,206	2,146
NCUSIF deposit	849	829
Other assets	337	203
Total assets	$114,122	$102,801
Liabilities and Members' Equity		
Members' shares and savings accounts (note 7)	$ 96,901	$ 89,135
Borrowed funds (note 8)	9,622	7,533
Accrued interest payable	160	166
Accrued expenses and other liabilities	49	39
Total liabilities	106,732	96,873
Commitments and contingent liabilities (note 9)		
Members' equity, substantially restricted	7,390	5,928
Total liabilities and members' equity	$114,122	$102,801

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 4)	$7,660	$8,011
Investment securities	3,015	1,610
Other	21	13
Total interest income	10,696	9,634
Interest expense		
Members' share and savings accounts (note 7)	5,807	5,370
Borrowed funds (note 10)	825	700
Total interest expense	6,632	6,070
Net interest income	4,064	3,564
Provision for loan losses (note 4)	900	966
Net interest income after provision for loan losses	3,164	2,598
Non-interest income		
Gains on sales of interest-earning assets, net (note 10)	21	34
Unrealized gains on trading account securities, net	3	4
Commitment fees	93	43
Loan servicing fees (note 11)	715	411
Insurance commissions	22	35
Other	46	23
Total non-interest income	900	550
Non-interest expense		
General and administrative		
Compensation and benefits (note 12)	1,162	1,040
Occupancy (note 9)	748	648
Other	692	517
Total non-interest expense	2,602	2,205
Net income	$1,462	$ 943

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*	*Total*
Balance at December 31, 19X0	$2,253	$2,732	$4,985
Net income	–	943	943
Change in market value	–	–	–
Transfers, net	52	(52)	–
Balance at December 31, 19X1	2,305	3,623	5,928
Net income	–	1,462	1,462
Change in market value	–	–	–
Transfers, net	260	(260)	–
Balance at December 31, 19X2	$2,565	$4,825	$7,390

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	$10,376	$ 9,588
Fees received	924	572
Insurance commissions received	22	35
Proceeds from maturities and sales of trading securities	73	101
Purchases of trading securities	(85)	(122)
Interest paid	(6,638)	(6,047)
Cash paid to employees and suppliers	(2,612)	(2,179)
Net cash provided by operating activities	2,060	1,948
Cash flows from investing activities		
Proceeds from maturities and sales of investment securities	2,477	1,874
Purchases of investment securities	(18,753)	(5,585)
Purchases of loans	(1,278)	(2,838)
Purchases of mortgage-backed securities	(116)	(223)
Proceeds from sales of loans	856	1,031
Proceeds from sales and maturities of mortgage-backed securities	95	115
Net decrease in consumer loans with original maturities of 3 months or less	53	16
Loan originations net of principal collected on loans to members	5,060	(10,222)
Increase in NCUSIF deposit	(20)	(28)
Proceeds from sales of other real estate owned	12	26
Proceeds from the sale of property and equipment	62	162
Expenditures for property and equipment	(303)	(438)
Net cash used in investing activities	(11,855)	(16,110)
Cash flows from financing activities		
Net increase in members' share and savings accounts	7,766	13,078
New borrowings	2,500	1,200
Repayment of borrowed funds	(411)	(305)
Net cash provided by financing activities	9,855	13,973
Net increase (decrease) in cash and cash equivalents	60	(189)
Cash and cash equivalents at beginning of year	689	878
Cash and cash equivalents at end of year	$ 749	$ 689

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

	19X2	19X1
Net income	$1,462	$ 943
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	178	167
Provision for loan and OREO losses	910	978
Gain on sale of securities	(26)	(36)
Gain on sale of mortgage-backed securities	(10)	(8)
Unrealized gains on trading account securities	(3)	(4)
Loss on sale of loans	15	10
Loss on sale of property and equipment	3	6
Changes in:		
Trading securities	(9)	(17)
Accrued interest receivable	(330)	(58)
Other assets	(134)	(59)
Accrued interest payable	(6)	23
Accrued expenses and other liabilities	10	3
Net cash provided by operating activities	$2,060	$1,948

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 $432 and $389 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. All sales are made without recourse.

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.

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 based on 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 borrower's 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 the lower of its fair value less estimated costs to sell or cost.

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.

Members' share and savings accounts. Members' shares are subordinated to all other liabilities of the credit union upon liquidation. Interest on members' share and savings accounts is based on available earnings at the end of

an interest period and is not guaranteed by the credit union. Interest rates on members' share accounts 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.

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 the 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	$ 24	$ 18
FHLMC certificates	69	63
	$ 93	$ 81

Note 3—Investment Securities

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

		December 31,			
	Weighted Average Yield at December 31, 19X2	*19X2*		*19X1*	
		Carrying Value	*Estimated Market Value*	*Carrying Value*	*Estimated Market Value*
U.S. government and federal agency securities	8.1%	$28,621	$29,912	$21,543	$21,464
Mutual fund of U.S. government and federal agency securities	6.3%	14,401	14,411	5,177	5,169
		$43,022	$44,323	$26,720	$26,633

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

	December 31, 19X2			
	Amortized Cost	*Gross Unrealized Gains*	*Gross Unrealized Losses*	*Estimated Market Value*
U.S. government and federal agency securities	$43,022	$1,621	$ (320)	$44,323
Mortgage-backed securities	1,322	231	(32)	1,521
	$44,344	$1,852	$ (352)	$45,844

	December 31, 19X1			
	Amortized Cost	*Gross Unrealized Gains*	*Gross Unrealized Losses*	*Estimated Market Value*
U.S. government and federal agency securities	$26,720	$ 231	$ (318)	$26,633
Mortgage-backed securities	1,291	—	(107)	1,184
	$28,011	$ 231	$ (425)	$27,817

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	$34,351	$35,080
Due after one year through five years	8,212	8,761
Due after five years through ten years	315	330
Due after ten years	144	152
	43,022	44,323
Mortgage-backed securities	1,322	1,521
	$44,344	$45,844

Proceeds from sales of investments in debt securities, including mortgage-backed securities, during 19X2 and 19X1 were $1,179 and $712, respectively. Gross gains of $50 and gross losses of $14 were realized on those sales in 19X2 and gross gains of $46 and gross losses of $2 were realized on those sales in 19X1.

At December 31, 19X2 and 19X1, securities carried at approximately $9,843 and $7,991, respectively, were pledged as collateral to secure borrowed funds.

Note 4—Loans Receivable

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

	December 31,	
	19X2	*19X1*
Automobile	$29,906	$32,464
Mortgage	12,409	12,658
Unsecured	9,401	11,856
Business	919	816
Lines of credit	612	533
Share-secured loans	893	1,215
Education	215	191
Credit card loans	544	-
Other	238	242
Net deferred loan origination fees	(281)	(264)
	54,856	59,711
Less		
Allowance for loan losses	1,157	760
	$53,699	$58,951

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	$ 760	$500
Provision charged to operations	900	966
Loans charged off	(594)	(791)
Recoveries	91	85
Balance, end of year	$1,157	$760

Loans on which the accrual of interest has been discontinued or reduced amounted to $2,343 and $1,862 at December 31, 19X2 and 19X1, respectively. If interest on those loans had been accrued, such income would have approximated $134 and $66 for 19X2 and 19X1, respectively. Non-cash transfers from loans receivable to other real estate owned were $50 and $30 for 19X2 and 19X1, respectively.

Included in loans receivable at December 31, 19X2, are loans of $483 to directors and officers of the Credit Union and its subsidiary.

Note 5—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	$19	$26
Provision charged to operations	10	12
Chargeoffs, net of recoveries	(4)	(19)
Balance, end of year	$25	$19

Note 6—Property and Equipment

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

	December 31,	
	19X2	19X1
Land	$ 53	$ 53
Building	1,553	1,530
Furniture and fixtures	982	874
Office equipment	144	37
Leasehold improvements	110	110
	2,842	2,604
Accumulated depreciation and amortization	(636)	(458)
	$2,206	$2,146

Note 7—Members' Share 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 noninterest-bearing deposits of $641 in 19X2 and $823 in 19X1	3.2%	$ 4,615	$ 4,262
Money market	4.1%	1,231	1,281
Share savings	3.8%	72,393	71,389
		78,239	76,932
Share certificate accounts and IRAs:			
0.0% to 4.0%		3,841	2,913
4.0% to 5.0%		10,211	3,328
5.1% to 6.0%		3,991	5,664
6.1% to 10.0%		619	298
		18,662	12,203
		$96,901	$89,135

The aggregate amounts of members' share and savings accounts over $100,000 were approximately $6,291 and $5,834 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
0.0% to 4.0%	$ 1,136	$ 621	$ 592	$588	$674	$230
4.1% to 5.0%	6,887	2,544	636	144	–	–
5.1% to 6.0%	3,241	216	454	80	–	–
6.1% to 10.0%	583	36	–	–	–	–
	$11,847	$3,417	$1,682	$812	$674	$230

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

	December 31, 19X2	December 31, 19X1
Money market	$ 80	$ 79
Share savings	4,576	4,461
Share draft	48	15
Certificates	1,103	815
	$5,807	$5,370

Note 8—Borrowed Funds

Borrowed funds are as follows (in thousands):

	December 31, 19X2	December 31, 19X1
Corporate Credit Union, variable rate (6.5% at December 31, 19X2), due 19X3, secured	$5,840	$6,115
Note payable to bank, interest at bank prime rate (6.5% at December 31, 19X2), payable in quarterly interest and annual principal installments through December 31, 19X9, unsecured	2,750	250
Certificates of indebtedness, interest at 5.0% to 8.5%, various due dates	1,032	1,168
	$9,622	$7,533

Scheduled maturities of borrowed funds at December 31, 19X2, are as follows (in thousands):

Years Ending December 31,	Amount
19X3	$6,392
19X4	1,599
19X5	816
19X6	503
19X7	210
Thereafter	102
	$9,622

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 9—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 or results of operations 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 expenses, was approximately $213 and $199 for the years ended December 31, 19X2 and 19X1, respectively.

The required 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	$206
19X4	192
19X5	180
19X6	99
19X7	99
19X8 and thereafter	115
	$891

Loan Commitments

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

	Fixed Rate	*Variable Rate*	*Total*
First mortgage loans	$3,210	$ 918	$4,128
Consumer and other loans	1,098	895	1,993
Lines of credit	216	124	340
Credit cards	93	—	93
	$4,617	$1,937	$6,554

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 condition. 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. The credit union is at risk from the possible inability of counterparties to meet the terms of their contracts and from movements in securities values and interest rates. However, the credit union's exposure to loss from those risks would be less than the contract or notional amounts of the options.

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	$6,554
Financial instruments whose notional or contract amounts exceed the amount of credit risk	
Purchased put options on loans held for sale	$9,500

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.

Put options are contracts that allow the holder of the option to sell a financial instrument at a specified price and within a specified period of time to the writer of the option. The Credit Union, in accordance with NCUA regulations, holds only long positions on put options for FHLMC certificates.

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 $551 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 10—Gain on Sales of Interest-Earning Assets, Net

Net gains are summarized as follows (in thousands):

	December 31,	
	19X2	*19X1*
Realized gain (loss) on sales of		
Mortgage-backed securities	$ 10	$ 8
Investment securities	26	36
Loans receivable	(15)	(10)
	$ 21	$ 34

Note 11—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	$ 4,821	$ 5,015
Other investors	5,215	5,322
	$10,036	$10,337

Custodial escrow balances maintained in connection with the foregoing loan servicing were approximately $612 and $591 at December 31, 19X2 and 19X1, respectively.

Note 12—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 twenty 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 one year 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	December 31, 19X1
Actuarial present value of benefit obligations		
Accumulated benefit obligation		
Vested	$ 818	$ 801
Nonvested	29	36
	847	837
Projected benefit obligation for service rendered to date	992	981
Plan assets at fair value; primarily listed stock, cash, and short-term investments	1,021	1,007
Plan assets in excess of projected benefit obligation	29	26
Unrecognized net gain from past experience different from that assumed and effects of changes in assumptions	(68)	(74)
Prior service cost not yet recognized in periodic pension cost	112	117
Unrecognized net transition asset (from adoption of FASB Statement No. 87) being amortized over XX years	(18)	(22)
Prepaid pension cost (included in other assets)	$ 55	$ 47

The components of net pension expense are as follows (in thousands):

	December 31, 19X2	December 31, 19X1
Service cost — benefits earned during the period	$ 62	$ 64
Interest cost on projected benefit obligation	26	31
Actual return on plan assets	(82)	(90)
Net amortization and deferral	26	25
Net pension expense	$ 32	$ 30
Assumptions used to develop the net periodic pension cost were		
Discount rate	7.75%	8.0%
Expected long-term rate of return on assets	7.75%	8.0%
Rate of increase in compensation levels	4.0%	4.0%

Note 13—Fair Values of Financial Instruments

The estimated fair values of the credit union's financial instruments are as follows (in thousands):

	19X2		19X1	
	Carrying Amount	*Fair Value*	*Carrying Amount*	*Fair Value*
Financial assets:				
Cash and cash equivalents	$ 749	$ 749	$ 689	$ 689
Trading account assets	93	93	81	81
Investment securities	43,022	44,323	26,720	26,633
Mortgage-backed securities	1,322	1,521	1,291	1,184
Loans	65,774	62,256	71,033	66,022
Less: allowance for loan losses	(1,157)	—	(760)	—
Loans net of allowance for loan losses	64,617	62,256	70,273	66,022
Financial liabilities:				
Deposits	96,901	94,420	89,135	86,031
Borrowed funds	9,622	9,622	7,533	7,533
Unrecognized financial instruments:				
Commitments to extend credit	6,554	6,325	6,832	6,454
Purchased put options on loans held for sale	15	16	17	17

Appendix B

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

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.

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

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. 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:

1. 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.

2. 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.

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).

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

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 or she 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.

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.

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.[1] As a result, changes may need to be made in the scope of either the entire supervisory committee examination or the CPA's engagement.

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

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[1] 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.

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 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.

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 [*Date*]
XYZ Credit Union

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.[2]

Our report will include a summary of the accounts and elements subject to our audit and the procedures performed.[3]

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 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

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[2] Some supervisory committee audits may not be conducted on a surprise basis or include consultation with regulatory agencies.

[3] 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.

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*][4, 5]

[*Date*]

[4] Preferably, the chairman of the supervisory committee or an outside director should acknowledge the procedures to be performed.

[5] 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.[6]
   - *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 the following:

1. Cash, cash items, and clearings and exchanges
2. Securities
3. Federal funds sold [*purchased*]
4. Loans and leases
5. Real estate owned

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[6] Independent auditors should refer to the policies of regulatory agencies on the use of supervisory information.

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.

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 note.**

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 nonprofit dues-supported trade association serving credit unions and credit union leagues in the United States.

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.

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.

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 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.

letter of understanding and agreement (LUA). A negotiated agreement between a regulatory agency or agencies and a credit union's board of directors concerning the credit union's problems, actions to be taken, and a timetable to complete each action.

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 include 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 NCUA *Rules and Regulations.*

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 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.

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.*

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